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NEW DIMENSIONS IN FOREIGN ECONOMIC POLICY

INDUSTRIAL - OIL - BANKING

FOREIGN SERVICE INSTITUTE
U.S. DEPARTMENT OF STATE

CENTER FOR THE STUDY OF FOREIGN AFFAIRS

The Center for the Study of Foreign Affairs, established in late 1982 as part of the Foreign Service Institute, aims to enrich traditional Foreign Service training by keeping government officials in many agencies abreast of emerging foreign policy concepts. Its program of conferences, research, diplomatic exercises and simulation, and publication combines new perspectives developed in the private sector with practical experience gained by foreign affairs personnel.

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CENTER FOR
THE STUDY OF
FOREIGN AFFAIRS

NEW DIMENSIONS IN FOREIGN ECONOMIC POLICY

INDUSTRIAL - OIL - BANKING

THREE SYMPOSIA:

National Industrial Policy (Japan - France - Korea - Brazil)

Ten Years After The First Oil Shock

The Future of International Banking

Edited by Ernest H. Preeg
and Diane B. Bendahmane
with an Introduction by Ambassador Preeg

1986

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The New Economic Diplomacy: An Overview

Ernest H. Preeg

This volume contains papers originally presented at three symposia on foreign economic policy held at the Center for the Study of Foreign Affairs. The specific subjects—energy, international banking, and industrial policy—may not appear closely related and certainly are not so in terms of day-to-day policy implementation. There is, however, an underlying theme in their joint presentation. In recent years a new era in U.S. foreign economic relations has emerged. It is characterized by more intense interaction between the domestic and international economies, and a correspondingly more integrated policy framework for dealing with economic issues. The three subjects treated here not only epitomize this new situation but were each central elements in its evolution.

The origins of this new era can be found in the decade of the 1970s. The trade liberalization of the 1960s—within Europe and on a multilateral basis—was producing a rapid expansion of trade just as dynamic new trade relationships, especially in East Asia and Latin America, blossomed forth. The prevailing monetary system of pegging to a fixed gold/dollar standard collapsed in 1971. Then came the first oil shock of 1973/74. The petrodollar reflows through the commercial banks to the developing countries set the stage for the second oil shock and debt crisis at the end of the decade. Consequent structural adjustment problems in almost all countries made import protection expedient and threatened an all-out trade war.

These tumultuous developments have had a profound impact on the political orientation of foreign economic policy. The contrast with the period of the 1950s and 1960s is striking. In those earlier years, practitioners of foreign economic policy concentrated on adjustments in tariffs that produced relatively modest changes in trade flows and on the arcane workings of International Monetary Fund (IMF) lending under fixed parity exchange rates. Domestic interests were, of course, at stake, at times important ones. There was a "chicken war" in 1963 between the United States and its European allies. But in general, and for the United States in particular, the scope of international economic issues, and the special-

ized institutional framework within which they were handled, made the whole business somewhat remote from national concern.

This earlier, rarified atmosphere has been swept away by the events of the 1970s, as evidenced by the papers in this volume. In each of the three subjects addressed, the dividing line between "domestic" and "international" policy is blurred, and the well-being of the U.S. economy is greatly affected by developments abroad. The following brief description of the issues, including some key policy implications, serves to highlight this central theme as well as to provide an introductory context for the discussion contained in individual papers.

Energy Prospects and Policy

The first oil shock of 1973/74 was caused by a global tightening of oil markets as growth in demand outran available supply and by the 1973 Arab-Israeli war. The price of oil shot up from $2 per barrel in 1972 to almost $10 in 1974. Consumer countries were initially in disarray and individual efforts to buy up available oil exacerbated the shortage. In 1975, most industrialized countries joined in forming the International Energy Agency (IEA), which was designed to coordinate reactions to existing and future emergencies. By 1978, the world economy was getting back to normal. Higher oil prices had acted to restrain demand and develop new sources of energy. As a result, oil prices had leveled off and had begun to drift down in real terms, trade was expanding, and the financial imbalance produced by oil exporter surpluses, or "petrodollars," had worked its way through the commercial banks to finance deficit-country needs, particularly in the developing world. Then came the 1979/80 oil shock from the Iraq-Iran war, and the price of oil on the spot market rose to $40 dollars per barrel. This time the industrialized countries, through the IEA, were better prepared, although a number of developing countries, particularly in Latin America, already over-extended in their external borrowing, built up unsustainable debts. The very high price of oil this time, however, caused an even stronger reaction in terms of conservation and alternative energy sources and led to substantial surpluses in the world oil supply. The Organization of Petroleum Exporting Countries (OPEC) tried to maintain the price of oil at $32 and then $28 through production controls, but only succeeded in seeing its share of world oil exports decline from 63 percent in 1979 to 46 percent in 1984. A sharp decline in price beginning in late 1985 marked the end of the OPEC price-fixing cartel. We now face the prospect of much lower oil prices in the short term, but most experts predict a new tightening of oil markets by the 1990s.

Policy Implications

• Although abrupt swings in the world price of oil can have high economic costs for national economies, the worst policy course is to try to insulate the domestic economy from such swings. During the 1970s, those governments that allowed higher oil prices to be passed on promptly to consumers were by and large better able to cope in terms of both short- and medium-term adjustment.

• International cooperation can make a difference in moderating the impact of oil shortages (and thus price swings). The IEA developed a system of information sharing, short-term demand restraint, and alternative energy supplies that reduced the disruptive effects of the 1979/80 shock, compared with the earlier one, on member economies.

• A key element of this cooperative approach, the coordinated buildup of strategic petroleum reserves, could be strengthened through more clearly specified conditions for their utilization in times of emergency.

• International oil shocks have greater relative impact on developing countries, whether importers or exporters of oil. For any future oil shock, something better is needed than the massive debt buildup of the late 1970s, which in any event will not be possible again.

• The longer-term outlook of gradually tightening oil supply, with a higher proportion of reserves (some 60 percent) concentrated in the Persian Gulf region, will increase further the strategic importance of that region to both industrialized and oil-importing developing countries.

International Banking in the Wake of the Oil Shocks

The total foreign debt of developing countries rose from $334 billion in 1977 to $749 billion in 1982, of which $326 billion in the latter year was in Latin America. The rapid buildup of debt was the result of ambitious, ill-managed growth strategies and the import cost of the second oil shock. The consequent heavy debt service, compounded by rising interest rates, was unsustainable, producing the debt crisis of 1981/82. Confidence in overextended commercial banks was shaken while borrowing countries faced the choice between default and painful economic austerity programs. Most debtors, including the largest ones—Mexico, Brazil, Venezuela, Argentina, and the Philippines—chose the austerity route while negotiating a stretch-out of debt with official and private creditors. The international financial structure of the mid 1980s, however,

is quite different from what it was a decade earlier. Debt service ratios for many developing countries remain precariously high, and commercial banks have cut back sharply on new lending. Net flows of long-term lending to developing countries dropped from $59 billion in 1979 to $40 billion in 1984; net capital transfers, defined as long-term debt less principal and interest payments, dropped from plus $34 billion to minus $15 billion over the period. Moreover, much of new lending by commercial banks is "involuntary" in that it is linked to refinancing packages negotiated between the host country and the IMF. The outlook is for continued lower levels of commercial bank lending and the consequent need for developing countries to put higher priority on generating internal savings and promoting exports to avoid another financial crisis. The international financial structure remains fragile and vulnerable to future economic shocks. Governments have been working toward a strengthened policy framework to foster greater financial stability and faster economic recovery in debtor countries, as discussed at the October 1985 annual World Bank / IMF meetings in Seoul. The United States proposed a strategy based on policy reform by debtor countries, increased lending by the World Bank tied to such reform, and a higher level of commercial bank lending. However, the specifics for such an approach, including the role of the private banking sector, still need to be elaborated.

Policy Implications

• Massive short-term lending by commercial banks to developing country governments should not (and in any event will not) happen again; a major policy constraint for the foreseeable future will be a lower level of such lending as private banks retrench portfolios.

• Private lending will be more closely linked to official lending through IMF or other policy-conditioned programs; such "involuntary" lending can create conflicts within bank management, particularly for regional banks that want to reduce external exposure.

• There will be more emphasis on direct investment, co-financing, and other innovative corporate financing techniques.

• Official lenders, including development banks and export credit institutions, will play a relatively larger role, both in terms of resource levels and policy conditionality.

• The quest for a broadly-based development strategy linking trade, investment, and internal growth policies will have to contend with

a very open commercial banking system that responds strongly to market signals on a country-by-country basis.

Industrial Policy and the International Economic System

Industrial policy does not have a precise definition, but in general it means the use of government powers to influence the industrial structure of a national economy. Policy instruments include trade policy, tax policy, the availability of credit, subsidies, and government financed research and development (R & D). Although it is nothing new, industrial policy has assumed greater prominence over the past few years for several reasons: (1) As tariff barriers were progressively reduced, governments turned to non-tariff measures to protect or nurture particular industries; (2) the disruptions of the 1970s caused by the oil shocks and the debt crisis created difficult structural adjustment problems that are often addressed in terms of targeted industrial policies; and (3) the emergence of the newly industrializing countries (NICs) as dominant exporters of many low-tech manufactures and the rapid development of high-tech industry, particularly in the United States and Japan, raise basic questions about the role of government in an increasingly dynamic and interdependent world economy. Industrial policies, in concept as well as practice, vary greatly by country. The United States is most committed to a market-oriented economy, with industrial policy limited principally to protection for industries seriously threatened by import competition, such as textiles and steel. Japan has used various means to target particular sectors for development and export, but does so on a more modest scale today compared with twenty years ago. Among the industrialized countries, France remains most committed to targeted industrial development, principally through allocation of credit, although the impact of this policy is constrained by competitive forces, especially within Europe. Most NICs, such as Brazil and South Korea, have based their development strategies on forceful industrial policies, but are running into difficult trade-offs between self-sufficiency and efficiency, particularly with respect to the allocation of limited investment resources in the wake of the debt crisis. The industrial policy issue has taken on special importance in light of the massive U.S. trade deficit, which has produced strong pressures within the United States, including some 300 bills in the Congress, to provide greater protection or other forms of industrial policy support for U.S. industry. The asymmetry between the more market-oriented U.S. economy and the more government directed approach—through industrial policy—elsewhere is fundamental to the trade policy debate. More broadly, the issue pits the multilateral, free

trade principles underlying the General Agreement on Tariffs and Trade (GATT) trading system against the more nationalist, control-oriented philosophy underlying most industrial policies.

Policy Implications

• Industrial policy is the central conceptual issue underlying the protectionist/free trade debate, including the prospects for a new GATT round of multilateral trade negotiations.

• Japanese industrial policy is more restrained than in the past and can be subject to negotiation toward freer and more open competition, as has been happening to some extent in the telecommunications sector over the past couple of years.

• Developing countries, particularly the NICs, face the greatest dilemma: Internally, they need to allocate scarce investment resources so as to create maximum employment, which can clash with grander designs dictated by politically attractive industrial policies; and externally, their government-directed industrial policy approach feeds protectionism in industrial countries, particularly in the United States, and thus threatens vital export markets.

The New Economic Diplomacy and the Foreign Service

All of these issues—energy dependence, the international banking system, industrial cum trade policy—demonstrate not only the linkages between the national and international economies but also the greater intensity and complexity economic relationships have taken on in recent years. Perhaps two other areas of policy—food dependency, particularly in some of the poorest regions of Africa and Asia, and the rapid internationalization of the information technology sector—should be added to the basic list of what can be called the new dimensions of foreign economic policy, or in terms of its implementation, the new economic diplomacy. There has been a quantum leap since the 1960s in the degree to which the U.S. economy is integrated with the world economy, and this has brought with it a range of policy issues that goes well beyond the traditional text on international economic policy. The principal purpose of this volume is to demonstrate the new dependency through pointed commentary by experts and practitioners currently engaged in its workings.

Since this volume is being published by the Center for the Study

of Foreign Affairs of the Foreign Service Institute, whose principal function is to provide professional training for the career Foreign Service of the State Department, it is appropriate that I conclude this introductory piece with some observations on the consequences of the new economic diplomacy on the professional needs of the Foreign Service. It is noteworthy, for example, that the moderators of the three symposia, who also contribute opening remarks here, are among the most experienced and able economic practitioners the Foreign Service has produced in recent years. Each has served as assistant or deputy assistant secretary in the State Department Bureau of Economic and Business Affairs as well as ambassador to one or more posts abroad. They represent the combination of economic expertise and diplomatic experience that is needed to meet the growing economic dimension of U.S. foreign policy.

Beyond these individual examples drawn from the senior ranks of the Foreign Service, however, it is less clear whether the Foreign Service career system is producing the requisite cadres of junior and middle-level economic officers to meet current and future needs. There are two basic questions involved: What kind of professional expertise is required by the economic diplomacy of the 1980s and 1990s, and how best can the Foreign Service recruit and develop such expertise?

As for the level of expertise, the major change compared with a decade or two ago is that economic officers today, by and large, need a more thorough grounding in analytic skills, particularly in the areas of finance, development, and macro policy. Much of the day-to-day economic work of the State Department, in Washington and in the field, remains dealing with discrete economic issues, be they in the fields of trade, investment, fishing rights, or airline routes, which may not require extensive formal training in economics. However, a growing share of the economic function pertains to policy assessment and implementation of broader and more analytic content. What are the realistic options for Peru in dealing with its overwhelming debt burden? How does the Japanese system of support for its telecommunications sector affect competing U.S. exports to Japan and to third countries? How will a substantial decline in the price of oil impact on the Mexican economy and its economic relationship with the United States? How can the United States and the World Bank link their financial assistance to policy reform in such countries as the Philippines and Zaire?

In the 1960s, the relatively few financial or "hard" economists in the Foreign Service tended to gravitate to assignments in the industrialized countries and to the Bureau of Economic Affairs in the Department, as the places where the more "sophisticated" economic work took place. Today, the head of the economic section in embassies in most developing countries

needs to be able to master the content of an IMF financial stabilization program, a commercial bank rescheduling package, or politically charged "policy conditions" on foreign assistance programs. Similarly, the five regional, or "political" bureaus in the Department have each built up their own economic staffs in recent years. Mid-level economic officers with proven financial/analytic expertise are in great demand within the personnel system.

If this assessment of professional economic needs in the Foreign Service is correct, and it is a broadly shared view, it follows that personnel policies should be directed toward more rigorous recruitment and career development of officers with strong economic training and experience. Until very recently, however, this was not the case, and if anything, the priority on developing economic expertise was on the wane. The Foreign Service has four general areas of functional specialization—political, economic, consular, and administrative—beginning at the time of recruitment, but such specialization has to be balanced with other competing needs or objectives of the Service, such as the predominance of consular work in junior officer positions, the requirements for hard language/regional expertise, and the development of well rounded "generalists" to assume senior positions in Washington and abroad. Personnel policy over the years tended to trade off the functional in favor of the generalist goals. In the early 1980s, for example, only a small fraction of new economic officers had graduate or even solid bachelor degrees in economics; almost all new economic officers spent their first two years and some their entire first four years in consular work, thus delaying career development in economic skills; mid-level training in the form of an academic year in graduate economic studies had declined from twenty to twenty-five officers per year in the 1960s to three or four per year; and "rewards at the top," particularly with respect to ambassadorial appointments, were skewed heavily in favor of the "political" compared with the "economic" officer. Such a state of affairs was hardly responsive to the challenge of ever more pressing economic issues.

Since 1983, thanks to the initiative of Secretary of State George Shultz, State Department management has been given the task of strengthening the professional competence of the Foreign Service in the economic field. Efforts are underway, among other things, to recruit new officers with stronger formal training in economics, to provide more junior-level positions in economic work, to increase mid-level university training, and to give more balanced treatment to economic officers in the senior assignments process. It is still too early to judge the results of this new priority on the economic function of the State Department, but the direction, at least, is the correct one in this era of more vital and inten-

sive U.S. interests in the world economy, the era of the new economic diplomacy.

* * *

The symposia covered in this volume were all held at the Center for the Study of Foreign Affairs (National Industrial Policy, December 1983; Ten Years after the First Oil Shock, February 1984; and the Future of International Banking, May 1984). Established in 1982 as part of the Foreign Service Institute, the Center directs research, conducts symposia, and publishes works on emerging issues of direct relevance to foreign policy decision-makers. Economic issues have been one of the Center's major themes—along with international negotiation and conflict resolution, science and technology and foreign affairs, and Soviet studies, to name a few. Other symposia in the economic series have dealt with such subjects as the GATT (General Agreement on Tariffs and Trade) which will be published in 1986, and LDC debt and growth.

Participants in the Center's symposia are leading academicians and businessmen, senior government officials, and distinguished private citizens. All symposia feature lively discussion and give-and-take between participants and the audience. In this volume each symposium is presented in abridged and updated form, with much of the discussion between the audience and participants omitted. Some excerpts from the discussion are included, however, as sidebars or inserts in the text. Also included in sidebars are brief descriptions of some major national and international entities mentioned in the text. A selected bibliography of recent works on the three subjects concludes the volume.

All views expressed here are those of the participants and do not necessarily reflect the current policies of the agencies they may be affiliated with. Comments on this and all other Center publications are welcomed.

Part One

Energy Prospects and Policy Ten Years after the First Oil Shock

1.

Introduction

Stephen W. Bosworth

As one looks back over the last ten years, it is striking how much our lives, both on a day-to-day basis and in terms of our national behavior and national interest, have been shaped and affected by the events which took place in the international energy markets in the 1970s. A good deal of the economic turmoil through which we have lived in the last ten years can be attributed directly or indirectly to what happened in the international oil market first in 1973 and then in 1979 and 1980.

It is equally striking that the consequences, inexorably rising demand for oil on available productive capacity, and subsequent events were so little anticipated by the world at large and in particular by people who had spent most of their lives working on energy issues. Today a lot of people would like to be able to say that back in 1969 or 1970 they foresaw what was going to happen to international energy markets and to the international economy as a result, but very few people can actually claim such prescience.

Today's symposium will attempt to draw some conclusions about what the future might look like in the area of international energy. Clearly we live in a different age than we did in 1967, but there is no reason for complacency about the events that may transpire in the international oil market over the next few weeks or in the international energy market over the next several years.

Ambassador Bosworth was Chairman of the Policy Planning Council of the Department of State from January 1983 to March 1984. He is currently serving as U.S. Ambassador to the Philippines.

2.

The World Oil Market

How We Have Changed Since 1973 — *Daniel Yergin*

Anyone trying to provide some perspective on what the future world oil market might look like who has been involved in the field knows how difficult that task can be. A director of one OPEC (Organization of Petroleum Exporting Countries) national oil company said, "Never have so many forecasters had to change their forecasts so often." Not so long ago, the vice president of one of the major oil companies remarked to me that his company might just as well fire everybody in the short-term forecasting department. He said, "In the last ten quarters, they've been wrong only ten times." In the energy scene there have been surprises for every analyst and every participant.

Massive Events and Massive Reactions

The events of 1973 and 1979 were massive, and in the last few years there has been an inevitable massive reaction. Now, with declining oil prices, we are in a pretty good breathing spell, but it is hard to say how long it will actually last. In the United States, as opposed to elsewhere in the Western world, there has been a strange unwillingness to see the connection between our rather poor economic performance of the last ten years and the two massive oil shocks. Yet the United States has paid a very heavy price, initially in terms of inflation, and then later in recession, unemployment, and monetary instability. One of the lasting consequences of these oil crises is the problem of structural unemployment, which the Western world is going to have to deal with through the rest of this decade and into the next. On the eve of the first oil shock, the number of

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Dr. Yergin is founder and President of Cambridge Energy Research Associates of Cambridge, Massachusetts. He is the co-editor with Robert Stobaugh of Energy Future *(New York: Ballentine, 1980) and of* Global Insecurity *with Martin Hillenbrand (Boston: Houghton Mifflin, 1982). He is the author of the forthcoming* Prize of the Venture, *a strategic history of oil. He was formerly a professor at the Business School and the Kennedy School of Government at Harvard University.*

unemployed people in the industrial countries totalled about nine million. By 1984, there were thirty-four million unemployed people.

Foreign policy implications are also wide-ranging. It is easy to dream up nightmare scenarios which involve regime changes in key oil-producing countries or the extension of Soviet influence and control in that area. Unfortunately one of the most unstable parts of the world is deeply involved in the oil problem.

Some years ago it was common to refer to the Middle East and Persian Gulf as the New Balkans. It seems to me that one could even go a little further than that and say that the Middle East and Persian Gulf are like the Balkans on the eve of World War I if they had been the source of coal for the entire industrial world. That gives some sense of what is at stake from a foreign policy dimension in the interaction between the politics of the region and the overall energy situation.

The shock of 1973 resulted from the conjunction of pressures in the oil market and the 1973 Arab-Israeli war. In retrospect, it is clear that something had to give in the market. Because the world had no surplus oil-producing capacity, price had to give—it was already beginning to move upward, but what could not be known was the way it would happen. All oil exporters were quite surprised at the end of the war to find out that

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Import Fees

The import fee question is really the interesting one in a paradigmatic way. Most administration energy analysts agree with me that the import fee is the best alternative to reduce oil imports beyond what the market has done. It's certainly better than various mandatory measures of demand restraint or specific stimulations of production. The real question is how much is gained from that relative to what is lost. If we had replaced all of the price decline since January of 1981—which in terms of the real price of imported oil has been nearly 40 percent—with import fees, that would have been a pretty heavy blow in terms of its effect on the economy. It would have reduced U.S. imports considerably below where they are now. However, I have never seen any political support for going to a pure import fee. The people who would support an import fee are the pure rational economists, to some extent the free marketers, and the oil producers because, of course, an import fee would redound to the benefit of domestic oil producers.

Danny Boggs

Mr. Boggs is Deputy Secretary of Energy.

the oil-producing countries had increased the price of oil by about $7.50 a barrel, given that up to that point the companies and the countries had been arguing about increases of 25 or 30 or 15 cents a barrel.

Today, clearly, at least one of those two factors is quite different. There is an immense cushion in the world market somewhere between eight and ten million barrels a day which is quite different from the situation in 1973.

Today the oil and energy situation is much more attractive than it was a decade ago in terms of the basic energy trend. A great deal has happened. In various parts of the world other energy sources—coal and nuclear—have been substituted for oil. Non-OPEC sources of oil have been developed in the North Sea, Alaska, and Mexico, and at least the North Sea and Alaska would not have been economic had it not been for the first oil shock. Most important, of course, significant conservation measures have taken effect. The United States is much more energy efficient today than it was in 1973.

Also improved over 1973 are the mechanisms which assist Western nations to respond with effective policies in times of crisis. The essential one is the International Energy Agency (IEA), which provides a framework for the speedy exchange of information that is so important in a crisis. There is a degree of expertise, experience, and organization that did not exist a decade ago.

In some respects, however, things are worse. A decade ago Shah Mohammed Rezi Pahlevi of Iran was the regional policeman in the Persian Gulf. He brought an element of stability. Today there is no particular sign of stability. In fact there is good reason to be concerned about further instability and further upheaval. In terms of the politics of the region that is most central to the future of world oil supplies, the picture looks a good deal worse.

In the last couple of years industrial nations have reoriented their energy policies and outlook. In the United States the most pronounced changes took place in the transition from the Carter to the Reagan Administrations. However, the dilemma between whether to focus on energy as a market or a security problem is on the agenda for all Western countries. The degree of change is suggested, not by looking at the United States, but by looking at Japan, the country that has put the most emphasis on energy security in the last few years. Because of its strong sense of vulnerability, Japan has actively moved in many areas to guarantee itself energy security. Today, however, Japan, as much as any other country, is backing away from an emphasis on energy security. The Japanese now see the effects of conservation; they expect a much lower energy demand; and they now believe that abundant supplies will continue in the years ahead.

The Energy Outlook for Industrialized Countries

A number of common themes currently infuse the outlook on energy of all industrialized countries. The first one is a much fuller recognition of the extent and potential for energy conservation. The second is a growing conviction that there is unlikely to be renewed upward pressure on the world oil market for several years to come. Third is a downplaying of the possibility of another oil supply crisis for the next several years, and thus a reduction in the security premium that societies are willing to pay—notwithstanding the news so far about the Iran-Iraq war. The fourth common theme is an awareness that the assimilation of surplus will dominate energy markets for the next few years. Countries are backing away from long-term, high-capital energy projects. The fifth is a national focus on the revival of basic energy-intensive industries. This is true in Japan and in the United States as well. The final common theme is a movement away from energy and oil as a matter of high government policy to energy as a matter to be sorted out in the marketplace.

The future also will feature the recurrent drama of whether the OPEC system will hold together. Obituary writing for OPEC has obviously become something like a cottage industry, but we must not forget that many people outside of OPEC have an interest in stable oil prices—such as Mexico, whose well-being is most important to the United States.

In spite of the breathing space we now have, there are some important factors at work that should remind us that the energy problem could reassert itself in an unfortunate conjunction of political and market pressures. One is the decline in U.S. oil production. In 1970 a similar

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The International Energy Agency

The IEA, a semi-autonomous body of the Organization for Economic Cooperation and Development, was set up in 1974 to develop cooperation on energy questions among participating countries. The IEA's program commits participating countries to share oil in emergencies and to strengthen their long-term cooperation in order to reduce dependence on oil imports. The IEA is also involved in promoting energy conservation, developing alternative energy sources, providing information and consultation on the oil market, and developing long-term relationships among oil-producing and oil-consuming countries.

The IEA's emergency oil-sharing system can be triggered if the IEA as a whole is suffering a shortfall greater than 7 percent. Also, any member nation experiencing a 7 percent short-fall can call upon other members to make up shortfalls above the 7 percent mark.

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decline was critical in opening the door to the first shock. Right now the industry is experiencing what has been described as the "mukluk" syndrome because of the $1.6 billion dry hole in Alaska, and a kind of pessimism about the U.S. supply base.

The second factor is a question. Will the demand for energy, and in particular oil, revive in the developing countries? Right now such a revival is unlikely, so burdened down are they by debt. Nevertheless, with recovery and lower oil prices there should be an increase in energy and oil use because developing countries are in the industrialization stage, and, as one person has put it, motorization is irresistible. There are about 600 million people in the newly industrializing countries who will want to have cars.

The third factor concerns when there will be a shift back to the residual supplier, to OPEC, in particular back to the Persian Gulf. Sixty percent of the known world reserves are concentrated in the Middle East and cheap and abundant reserves in the Persian Gulf region. If the call for Persian Gulf and Middle East oil increases, we could find ourselves with a tighter market, one much more vulnerable to the accidents that might occur in the future. In such a case, the world oil market could again be in jeopardy. Once again the world economy and political system would find itself moving back into the danger zone.

These are some of the questions we should be struggling to answer—recognizing that the answers will be imperfect.

Preparing for Future Surprises—*Clement B. Malin*

Ten years after the first oil shock we can look back and recall the surprising lessons we learned. The overriding lesson was that price, in fact, does matter, and many of the surprises I am going to discuss are related to that.

Surprise number one: there is elasticity of oil demand, notwithstanding what the oil industry believed. The industry, which had witnessed a decline in real prices for oil over the prior 40 years, believed that this demand was going to continue ever upward. They thought Saudi Arabia would be required to produce 20 million barrels a day by 1980. Instead we have had a permanent structural change in demand: cars are more efficient, our own preference for the temperature in our homes has changed, etc.

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Organization of Petroleum Exporting Countries

OPEC was established in 1960 to unify and coordinate the petroleum policy of members and to safeguard their interests. Thirteen countries belong to OPEC:

Algeria	*Iraq*	*Saudi Arabia*
Ecuador	*Kuwait*	*United Arab Emirates*
Gabon	*Libya*	*Venezuela*
Indonesia	*Nigeria*	
Iran	*Qatar*	

In 1982 OPEC countries possessed an estimated 67 percent of known petroleum reserves and 32.8 percent of known natural gas reserves. OPEC's production has diminished over the last decade. In 1973, before the embargo, OPEC members were producing 55.5 percent of world petroleum; by 1985 this had fallen to 30 percent.

Surprise number two: price matters with respect to elasticity of supply. When the first oil shock came, we wrung our hands for several months and then got on with the job of bringing the oil down from the North Slope of Alaska. Tremendous reserves were developed by Mexico and brought on stream. North Sea oil suddenly became attractive to produce. Fields which were virtually abandoned in the United States were worked over, and areas in which it had previously been too costly to look for oil were explored. The technology of deeper drilling enhanced oil recovery. And so on.

Surprise number three: suddenly oil had politics attached to it. The international oil industry had been dabbling with Middle East politics for years. However, in the early 1970s, producer countries nationalized their oil resources—some with and some without prompt and adequate compensation. Oil companies had to find a replacement for the loss of earnings. The oil-producing countries learned about cartels. When the market is tight, the economic motivations suggest cohesiveness, but when the market is relaxed and there is excess capacity, it depends on a couple of countries' willingness to manage the market.

Surprise number four: consumer countries became engaged in the politics of oil. In the United States oil became a matter of national security. We engaged in emergency preparedness and filled the strategic petroleum reserve. The IEA was established. We experimented with controls, price allocations, and entitlements. Outside the United States, other countries also made significant strides in reducing their dependence on oil,

and the politics of oil extended to developing countries. The tremendous impact that the oil price rise has had on balance of payments and their development plans is well known.

Surprise number five has been the oil companies' response. How did we in the oil industry react to the dramatic change? We responded in the way we had to in order to do our business. By and large oil companies make more money when prices are rising than when they are falling, not surprisingly. In an emergency, ironically, the larger the company, the more likely it is to allocate oil equitably; it may in fact react in a non-market way. Oil companies are in it for the long term. They have a lot of customers all around the world and do not respond simply to market-oriented opportunities during emergencies.

Oil companies moved out of OPEC exploration and production largely by default and moved into frontier areas in the North Sea, the North Slope of Alaska, and a lot of areas they had earlier abandoned in the lower 48 states. They spent a great deal of money upgrading refineries worldwide to process not only the heavier and higher sulphur crude oils, which are in greater abundance than the more desirable lower sulphur and lighter crudes, but also to provide the marketplace with the so-called lighter ends of the barrel, the gasoline and distillate range, as opposed to the residual fuel. The residual fuel, the heavy end, which is typically used by industry, has recently fallen in price more rapidly than the heating oil and gasoline end of the barrel.

During the 1981-82 period of recession the Soviet Union has become an oil trader. That is somewhat of a new role. In the early and mid-1970s the Soviet Union was selling only about a million barrels a day to the Western world.

Planning for the Next Twenty Years

With all those surprises behind us, the first thing we should do in the future is to make sure that we are ready for surprises in the future. There certainly are all sorts of possibilities in the Middle East for intended or accidental events which could disrupt current plans. Since the cost of planning against a disruption is far less than the cost of an actual disruption, the oil industry supports such things as the strategic petroleum reserve and emergency preparedness policies—obviously with some limitations. It has supported and continues to support the IEA as a vehicle for coordination of energy policies among industrialized countries.

In the industry we engage in something called "flexible scenario planning." However, in the end all planning requires someone to make a decision and take action. Industry officials, unlike academics, cannot stand

back and maintain all their options. They must establish long-term objectives and then find the most straightforward ways to reach them.

There are two constants or trends that we can probably count on over the next twenty years, which is the planning horizon. Constant number one: the world will need oil to the year 2000 and beyond. There is no plentiful, viable substitute available or in the offing. Unfortunately, the balance of that oil power will be shifting back to the Middle East producers. U.S. production is likely to continue its modest decline. The development of alternative energy sources is lagging in the United States. The North Sea is going to peak in the mid-1980s. Mexico's policies are uncertain, and China is certainly speculative at the moment.

Constant number two: economic growth projections must be scaled downward from what was enjoyed in the 1960s and probably even the 1970s. Demand for oil, therefore, will not grow very fast, if it grows at all. The developing countries will not expand their use of energy as we would have projected just a few years ago. Budget deficits and reordering of spending priorities will cause both a higher tax burden to be placed on the industry and will reduce the support that may be available through the tax system or other programs for alternative energy development.

We remain an industry, moreover, of excesses. We have too many refineries, and ultimately some of them must close. We have too many tankers, some must be scrapped. We have too many service stations. In short, consolidation is called for within the industry.

Most of the so-called upgrading investments have been made: the ability to destroy the heavy residual fuel is pretty well complete in the United States, and there are a number of projects coming on stream in Europe.

Some operational changes will take place in the industry. Major companies such as Texaco will begin to trade. It will be necessary if supplies are to be maintained since companies no longer control the amount of crude they want. Also there are opportunities for profit. The industry will begin to purchase product from OPEC refineries and engage in joint ventures with OPEC nations even more so than it has in the past.

The future should bring some strides forward in technology, especially in terms of our ability to drill deeper and further offshore and in inhospitable territories. Oil, however, is a long lead-time industry. Short-term forecasts are not much help.

The United States is a nation of crisis lovers. We are good at rallying around and putting aside our differences to get on with the job. But we are also impatient to resolve issues. That was obvious in 1973 and 1974. Now we are passing through a grace period during which we have time to get our house in order. I hope that we will use this opportunity so that we can indeed stay the course in this energy transition.

Lessons of the Past—*John P. Weyant*

Dependence on Imported Oil Makes Us Vulnerable

In the last five years, there has been a greater appreciation of the fact that the cost of sudden increases in oil prices are much greater than those associated with gradual increases.

In the mid-1960s there was some appreciation for the dependence phenomenon and problems associated with it. A quota system was established but was abandoned, unfortunately, in the early 1970s, mostly to help stem the tides of inflation. After the Arab oil embargo, there was a greater concern about dependence, but it was not until the late 1970s and early 1980s that the vulnerability problem was recognized as distinct from the dependence problem.

The vulnerability problem was more than just an economic calculation. Oil came to be viewed by a great majority of analysts as unlike other commodities. The last four U.S. administrations have stated that they would go into combat to defend the oil supplies from the Persian Gulf. I can think of no other commodity in recent history that has been given quite that importance.

Oil Is Depletable

Once a particular pocket of oil has been produced, it cannot be produced again. Naturally people in the oil business try to produce the least-cost prospects first. Technological advances in finding, developing, and producing oil prospects can be expected to offset the effects of depletion to some extent. Those have been considerable partly due to the better price incentives that now exist. But the fact is, even in a highly technological environment, such as the United States, advances in technology have been barely able to keep us even in terms of production.

In the last five years or so there has been a tripling in oil exploratory efforts. That has increased the fractional rate of discovery of remaining resources by about 50 percent, which in turn has increased the absolute reserve additions per year by 30 or 40 percent. All that has left oil production just about flat.

The other offsetting effect that people often point to is the new frontier phenomenon: the North Sea, Alaska, Mexico, and the Santa Maria Basin. But, now there is a significant decrease in the rate at which we are finding giant and super giant fields. It must be concluded that it will be hard to increase non-OPEC production very much for more than a few years without higher oil prices.

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The Rate of Oil Production from a Particular Pool Depends on Who Controls the Pool

In 1973, when the control of the Middle Eastern oil fields passed from the multinational oil companies to the low-absorber developing countries in the Persian Gulf, production expanded much less rapidly and prices were much higher. In this regard it is important to realize that most of the remaining oil reserves—in particular the very low cost reserves—are in the Persian Gulf. That alone ensures the reemergence of market power on the part of at least the Persian Gulf producers.

Most of the oil rich developing countries view natural-resource development in a fundamentally different way than those of us in the developed world. Natural resources are considered a part of a country's patrimony. It will be very difficult, but recognizably necessary, for countries like Mexico and the Middle East to price oil domestically at world-scale levels. The conclusion to all this is that it will be difficult to reachieve 1979 levels of total world oil production without significant increases in oil prices.

On the demand side of the market, the effects of conservation, fuel substitution, product mix changes, and so forth did not show up until years after 1973 and 1979 because most of the use of oil is tied to capital and investment which by and large turns over relatively slowly. Today we are still seeing adjustments in energy use per unit of output. The incremental effect of the 1973 and 1979 oil price increases, that is, the rate of decrease in oil consumption per unit of economic activity is declining year by year. There is still an increase in the cumulative effect, but the incremental effect from both of those oil shocks is now more or less on the downturn.

The Level of Economic Activity Has a Significant Effect on the Level of Oil Demand

The effect of economic changes and economic activity on the level of oil demand is more or less proportional. The econometric evidence ranges from 0.7 to a 1.3 proportionality constant, but there is a definite notion that more economic activity leads to higher oil demand, if other things, namely prices and technology, remain constant.

A lot of research will be devoted to sorting out how much of the production capacity that was taken out of service during the recent recessionary period (a lot of it energy-intensive because energy-intensive industries were cut back more than most) will actually be put back into service as we come out of the recession. I suspect that in this particular recovery a lot of the smokestack industries will be put back into service.

It will be difficult to keep demand below its 1979 level worldwide without significant increases in prices. My punch line is that expansion in economic activity and depletion effects will lead to a situation where price increases will be required to balance the oil market, despite technological advances on the supply and demand side of the market. Upward trends in prices will emerge before 1990 as OPEC gets back up into the 30-million-barrels-a-day range.

Upward pressure will likely continue well into the next century. The textbook idea that there might be a particular technology that could put an absolute cap on oil prices does not have a great deal of practical use. The textbook definition requires an unlimited supply at a fixed price at some point in time. Perhaps synfuels could be produced for $60 or $70 a barrel, after the engineering development fees and so forth, but no one would expect the same prices in 1995 or whenever the price of oil goes up to $60 a barrel.

It is important to allow for a price jump brought about by a non-disruptive event. For example, the market might suddenly get tight, speculators recognizing that first and the rest of us a little bit later. An analogous situation occurred in the aftermath of the Iran revolution. Then there was actually very little oil physically taken off the market but very substantial price increases. It is not completely out of the question for the market to get tighter suddenly; the response would be a sudden jump in prices.

3.

Energy Security

The Most Important Element of Energy Security

—J. Wallace Hopkins

The most important element of energy security relates directly to how energy markets and particularly oil markets develop in the future. The second and less important, perhaps even less interesting element, is the question of what to do when things get out of hand.

In terms both of general energy supply and demand overall, the past ten years have brought a number of ups and downs and some rather sharp learning curves for all concerned: 1973 and 1974—oil shortages, embargoes, higher prices, lower demands, and economic recession; the late 1970s—economic recovery, steady prices, growing demand, and capacity production; in 1979 and 1980—interruptions, shortfalls again, higher prices, recession, shrinking demand for energy (particularly oil) and growing non-OPEC production of all fuels. It is unclear, however, whether or not this pattern will be repeated over the next decade.

There has been very considerable structural change in the economies of the OECD (Organization for Economic Cooperation and Development) member countries arising from new patterns of energy consumption. Efficiency has improved tremendously; dependence on oil has dropped from over 52 percent to around 44 percent in just ten years—not a huge swing, but a very significant one in terms of volume of oil. At the same time production of all fuels within the OECD has increased significantly.

A Shift Back to Tighter Oil Markets

We can probably expect a period of oversupply for the next two to four years, followed by a shift back toward tighter oil markets during the following five or ten years. A number of negative factors point to eventual tighter oil markets. Conservation and substitution brought about

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by higher prices and encouraged by government policies will tend to wear off. A significant reduction in North American and North Sea oil production can be expected. There is limited scope for increased exports from centrally-planned economies. But the most important factor has to do with OPEC production. As far as we can see, this decade and certainly the decade beyond it are going to bring shrinking reserve production ratios in a number of OPEC countries. Over time this will tend to reduce their technical capacity. What's more, the OPEC countries that will not be affected by shrinking production are concentrated heavily in the Persian Gulf region. Even today it is obvious that future supplies of refined oil products and petrochemicals are also concentrated there. Also the region is demonstrating a degree of political cohesion, as expressed in the Gulf States Cooperation Council. What this means is that our attention, particularly in security terms, will focus on that part of the world, with all the uncertainties and hence potential insecurities that that implies.

Another negative factor is that some countries may not be able to rely as much as they anticipated on coal and nuclear power. Similarly, the U.S. gas bubble might burst, and a recoupling of energy and economic growth is possible, maybe not back to the so-called 1.0 ratio of the 1960s and early 1970s, but probably closer to it than the 0.7 that we have achieved just recently.

There are also some positive factors that have to be taken into account by anyone who is interested in energy security. The first is the possibility of much lower economic growth. However, since it is not a very popular view for politicians to hold, or at least to admit they hold it does not really form a very sound basis for political planning.

The Strategic Petroleum Reserve

The SPR was established in 1975 as part of the U.S. Energy and Conservation Act which stated it was "the policy of the United States to provide for the creation of a strategic petroleum reserve for the storage of up to one billion barrels of petroleum products, but not less than 150 million barrels of petroleum products, by the end of the three-year period which begins on the date of enactment of this act." Currently the goal is to store 750 million barrels. By 1985 450 million barrels had been stored, at a cost of $15 billion. Storage domes located in Texas and Louisiana have a capacity of 600 million barrels; pipelines connected to the domes are hooked up to a natural distribution system. Two policy questions regarding the SPR remain unanswered: When should the oil be used? and How should it be distributed?

Second, there may be massive future oil and gas discoveries. It is not very likely, though, and is not a very strong reed to hang onto for those who in the end are responsible for national economies. Some countries are still counting on massive further conservation in their energy policies. Like future discoveries, that is not impossible, but most populations are not going to be enthusiastic about energy austerity.

Finally, there is a possibility that the Soviet Union and Iran might become reliable suppliers of large quantities of natural gas and maybe even some oil. Surely the West's relationship with both of these countries will not be the same in 1995 as it is in 1984, but no one knows whether it will improve or deteriorate.

None of these factors is meant to be facetious, although some sound far-fetched. There is a possibility that every one of them could affect the energy supply-demand situation and hence energy security.

Preventing Imbalances Between Supply and Demand

The first and greatest commandment for energy security is to employ all means available to prevent an imbalance from developing between energy supply and demand or to avoid becoming over-dependent on a single source. The second commandment is to be prepared for an emergency if one arises.

In the crisis of 1973 and 1974 governments did not respond at all in the beginning; they just panicked because there was no information available on what was actually happening and what its impact would be. There was no preparedness planning and only a limited understanding of the real issues. The result was a high degree of political tension.

Quickly thereafter, of course, governments did start reacting and thinking together and the IEA was the result of that. Industry, for its part, did provide the mechanism for a reasonably fair distribution of short supplies.

In 1979 the response to the shortage was to reduce demand by almost 5 percent through agreement within the IEA. It was a tentative agreement taken without a great deal of conviction, and with not much political engagement behind it. Very little distinction was made between consumption on the one hand and total demand, including stocking positions, on the other. Again, there was not enough information. It took us two months to figure out what was happening and to decide what to do.

In 1980, adequate information was available because of the 1979 experience. Within ten days, decisions were taken and they were taken with more conviction than in 1979. Reserve stocks, which happened to be plentiful, were drawn on heavily. Spot-market activity was kept within

some degree of reasonableness to avoid adverse impacts. Production was increased and an effort made to dampen consumption, which, by then of course, was already moving down because of the events of 1979 and the resulting higher prices.

Basically only two things can be done in a supply shortfall. One is to increase production and the other is to reduce demand. Unfortunately in the short-term neither of these is easy and neither can be brought about at once by price rises, even substantial ones. Of course, if supplies are increased by using excess capacity, by definition there is no emergency. Against that possibility oil companies, throughout their histories, have held stocks and then used them when necessary. That is not an invention of the IEA or any recent policymaker, but it is still sound policy. Although consumption does not respond immediately to rapid price increases, there are means for encouraging and influencing consumption even-handedly and gradually in a downward direction.

These two basic actions—drawing on stocks and bringing consumption down—are the fundamentals of the IEA sharing system, though details of method vary from country to country. The two are complementary. If a country, for example, was in a position to draw on huge stocks, then it is not required to reduce demand. Similarly, if demand is reduced heavily, there is no obligation to draw on stocks.

The IEA system is based on sound principles and its mechanics are in excellent shape. They have been tested, and they work very smoothly. To date no government or significant company has given any sign that its commitment to that system is weakening.

Relying on Unfettered, Decentralized Market Decisions
—George Horwich

Throughout the 1970s, U.S. energy emergency responses, including price ceilings, mandatory allocations and government market interventions of all kinds, accomplished absolutely nothing by way of

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improved efficiency or fairness in the oil market. If there is a role for government in the emergency response area, it is to reduce the costs of adjusting to any new economic equilibrium constrained by less oil. This has not been done in the past. Instead, price ceilings on domestically produced oil had the effect of discouraging domestic production, increasing imports, and, by virtue of having diverted demand from the domestic market to the world market, raising the world price of oil.

Coupled with the crude oil price ceilings was the so-called entitlement system, an averaging process in which all buyers of petroleum paid roughly the same average price, somewhat below the world price. This had the effect of increasing total consumption, as well as imports. It exacerbated the effects of the domestic crude oil price ceilings. The best estimates are that total U.S. demand for imports rose about two million barrels per day on a six-million-barrel base—roughly from six to eight million barrels—as a result of these policies.

Since imports were available to absorb unsatisfied domestic demand, there was no particular necessity for mandatory allocations in the crude oil market. However, the United States did choose to impose them. There were a number of programs, the chief one being the so-called supplier-purchaser freeze, under which all sellers of crude oil, as well as petroleum products (except at retail), were required to continue selling the same percentage of supplies to each buyer that they sold in the corresponding month of 1972. This rule makes little sense under normal circumstances of market process and absolutely none at all under conditions of disruption when the optimal allocation of resources changes radically under the changed prices that result from an energy disruption.

There is no way that anybody in a position of central authority can know what the most efficient allocation of resources should be under such changed circumstances. Maintaining normal ratios may appear to provide a certain measure of fairness but it clearly will not serve any general efficiency interests.

The attempt to establish these allocations—to prioritize the uses of petroleum—flies in the face of what we know about optimal uses under changed circumstances. The elasticity of demand for gasoline is much lower than it is for heating oil. This is not hard to understand. There are fewer alternatives for gasoline than there are for heating oil. People have managed to find these substitutes in very short order, and they have shown a great willingness to turn down thermostats and take other heating conservation measures. In this country, transportation—automobile use in particular—is not so flexible from an economic point of view; there are no short-run substitutes.

The automobile, moreover, is an extremely important resource, a

Freeing the System

It is important to look back and remember what the government projections of oil production were in 1980 before the advent of oil decontrol. Today in the United States, we are running a million barrels a day ahead of virtually all of those government projections, and prices are lower than what was being projected. A large portion of that is attributable to the fact that not only were prices freed, but the whole system was freed. People did not have to come near Washington in order to go out and try to find oil in the most sensible places at the most sensible prices. I would argue quite strongly that, if we had retained the regulatory system, we would not have been able to reap the benefits of increased production.

Over the past two or three years, U.S. policy has resolutely set its face against any type of intervention in the market. That has had the effect of not creating crises when we could have had them. In 1982, a spate of stories said that we were ready for gasoline lines on the fourth of July. If the government had stepped in to prevent them, that could have brought them about very easily. Instead of intervening, the government should encourage the private sector to make its own types of preparations for shortages and for run-ups.

Danny Boggs

factor of production, in fact, in the determination of U.S. gross national product. The United States has a very low-density population, possibly the lowest of any advanced industrial nation, with the possible exception of Canada or Australia. Our urban density alone has fallen by 50 percent in the last 30 years, and there is no sign that this trend has abated. Given this phenomenon, transportation is too important economically to be cut disproportionately in an oil-supply disruption. The suggestion that there is some kind of an equity standard or some perception of efficiency which emanates from Washington and that can correctly prescribe the allocation of petroleum among the various competing uses is an illusion.

In the petroleum product markets, the price ceilings were somewhat more flexible than they were in crude oil. For example, the regulations allowed crude oil costs to be passed through to the prices of heating oil, gasoline, jet fuel, and so on, but, from the viewpoint of allowing a market economy to function, the regulations made the fatal error of freezing profit margins. In other words, the underlying mechanism by which resources are distributed, namely the constant increases and decreases in the profit margin, often of just fractions of a cent, was not allowed to work under the control system. This is not to say that there were no adjustments in the profit margin. At infrequent intervals, upward

Using SPR Oil

Congress has pushed both the Carter and the Reagan Administrations to fill the strategic petroleum reserve. There has been a good effort to do that, and the reserve is now close to 400 million barrels. That is now a credible tool.

The next thing we ought to be able to do is to use the reserve in a hurry in a disruption. I am worried that, instead of using it when the time comes, we will just let it sit there in salt domes in Louisiana and Texas. We won't use it for any one of a number of reasons, none very good. We may think the shortage is going to get worse tomorrow or the next day or next year. Or we may wish to hold it for a military purpose later on.

It is not difficult to see what we ought to be doing in terms of our strategic petroleum reserve policy. We ought to put 150 or 250 million barrels in a military contingency reserve, but anything beyond that we should feel free to use during a supply disruption. It should be sold at a market price rather than given away or sold at a subsidized rate. What's more we ought to use it early. We ought to use it before supply disruptions have their predictable effects on stock market prices. One way to do that is to sell a little bit in futures options. In anticipation of supply disruptions, futures options can get oil on the market and can have a calming effect on disruptions.

The current law requires the President to declare an emergency before the strategic petroleum reserve can be used. That's likely to have a destabilizing effect on oil markets. What we need is some kind of legislative change, a minor change, to allow the President to sell futures or to do something to get some oil on the market before the damage is done.

William Taylor

adjustments were made across the board, and, from the viewpoint of a free market, they were far greater than would have occurred in the absence of controls.

The so-called exceptions relief program transferred massive amounts of money—tens and even hundreds of millions of dollars—to both large and successful companies and small, unsuccessful, and sometimes patently inefficient entities as well. Small refineries were given enormous assistance through extra allocation of entitlements. In fact, fifty or sixty refineries with extremely limited capability, producing the heaviest ends of the petroleum barrel at the highest imaginable costs, were brought into existence for a four- or five-year period through the assistance program. Many of their owners became instant millionnaires, but with no

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gains to the U.S. refinery industry in the form of enhanced competition or efficiency.

The only way to avoid the mistakes of the past is to plan assiduously to do so. The United States should prepare to rely on unfettered, decentralized market decisions. There is a great deal of evidence already in hand that the market is capable not only of longer-run responses but also of the very short-run responses that are required under disruption scenarios. A fascinating set of surveys that was conducted for the New York State Department of Transportation on how motorists in New York State responded to the disruption in 1979 showed a diversity of completely unpredictable, yet highly effective, responses to a 6 percent gasoline shortfall in 1979. There was no way to anticipate the responses, control them, regulate them, or to do anything except to let them happen. There were some interesting findings. (Admittedly market conditions were not completely free, but there was a combination of de facto price increases and shadow price increases—and hidden costs resulting from queueing and searching for gas that provided the incentive to adjust to the shortfall.) The surveys showed that fully half of the gasoline saved was saved by people who owned two or more automobiles—in other words, the upper spectrum of the income class. A surprisingly large fraction of the gasoline was saved by turnover of the automobile fleet toward greater fuel efficient vehicles.

For the future, the centerpiece of the U.S. response should be the strategic petroleum reserve (SPR). We are approaching 400 million barrels. I would like to see it reach 750 million or a billion barrels if only to ensure that we would be likely to use the 400 or 500 million that would be required following a Middle East supply interruption. We have enough now to draw down at a rate of 1.5 million barrels a day for about eight months. That is likely to be an adequate amount for any foreseeable disruption, including the closure of the Strait of Hormuz.

Building the SPR is an appropriate government function. There are externalities, that is, costs that are not borne by private individuals involved in buying, selling, producing, and stockpiling oil. Nobody takes account of the enormous costs of oil supply disruption, of the vulnerability that we face when buying overseas oil. Nobody takes full account of the GNP and employment costs, including the adjustment costs that result from interruptions in supply.

It is extremely important that there be a mechanism for automatic SPR drawdown. It could be done through the establishment of an options program whereby traders buy claims to purchase SPR oil at some future date two or three months down the line at today's price plus a penalty of, say, 10 percent. This would guarantee automatic drawdown, when prices rise sufficiently, based on the opinion of tens of thousands of traders whose

livelihood depends on their ability to make that decision correctly, a decision that no single individual or government should have or is qualified to make alone.

The SPR should be funded by a two-dollar import fee. That would be more than enough to handle the funding of the SPR for all future time. Revenues from the sale of SPR oil, automatically funded and automatically drawn down, should be handed over as block grants to the states to be used at their discretion to take care of severe economic hardship cases and providers of emergency services.

There are enormous advantages from coordinating stock drawdown among nations. If it is good for one country, it is more than doubly good if all the OECD countries do so together. However, it would not be in the U.S. interest to delay for even a day its own unilateral stock drawdown. All simulations that have been done indicate that the United States would benefit from immediate and massive drawdown of the SPR. It is during those first four, five, or six months that we would really need it to moderate the price increases. After that, the normal market adjustment responses would be quite adequate.

4.

U.S. Interests and Foreign Policy Concerns

Two Kinds of Threats to U.S. Energy Supplies

—William B. Quandt

U.S. energy interests in the Persian Gulf are fairly simple to delineate. The first is to do whatever we can within some notion of appropriate costs to avoid the domination of the Persian Gulf region by any power hostile to the United States or to its allies. In other words, the United States is not indifferent to the big threat, namely the possibility of Soviet domination of the Gulf, or in more immediate terms, domination of the region by a country such as Iran which is, at least at present, very hostile towards the West generally.

The second energy-related interest is to insure that the flow of oil from the Gulf is unimpeded. The kinds of threats that can be mounted from the Gulf region against the flow of oil are fairly easy to identify. Today the Iran-Iraq war has already resulted in a significant amount of oil being removed from the world market. In 1979, an internal upheaval in one of the key Gulf countries, Iran, removed a significant quantity of oil from the world market and resulted in price increases, and in 1973 Gulf countries restrained production and imposed embargoes on shipments of oil for politically-motivated reasons. Those are recent examples of how oil from the Gulf can be taken off the world market. Not all of those incidents resulted in comparable costs to the world, but the 1973 Arab-Israeli war and the 1979 Iranian revolution were extremely costly indeed.

A third interest that can fairly easily be identified, a derivative of the first two, is that in the event that there are disruptions of oil supplies of significant magnitude, it is clearly in the interest of the United States to limit their duration and magnitude so that they have the least disruptive economic consequences for the world.

Today the two specific threats most on people's minds are the Iran-Iraq war and the somewhat less immediate concern with instability in

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What Explains OPEC Behavior

I have devised three tests of the hypothesis that optimizing the economic returns from oil resources is the best explanatory way of looking at OPEC behavior. The first is to look at OPEC decisions in terms of short-term economic maximization. The second is a model in which we take into account leaving oil in the ground versus selling it and having money in the bank now. The third test is to say that, in fact, what OPEC is trying to maximize is not short-term gains, but rather the long-term viability of themselves and the Western system as both consumers of oil and a financially stable set of institutions. However, none of these tests check out in terms of OPEC behavior.

What I have discovered is that oil policy, particularly for Saudi Arabia, is used for other purposes than to maximize economic short-term or long-term economic gains. One purpose is to send signals to Washington. Another is to support broader Arab goals in the context of the Arab-Israeli confrontation. And a third is to demonstrate either fear or anxiety or respect in relation to the larger Gulf powers, particularly Iran.

This leads me to suspect that we are likely to see the re-emergence of OPEC oil politics as soon as the market begins to strengthen. We will not have to wait until the market is as tight as it was in 1979. As soon as basic supply and demand conditions move back toward balance we are likely to find ourselves back in the oil politics of the 1970s.

Theodore H. Moran

Saudi Arabia. The Iran-Iraq war, insofar as it poses a threat to energy security, may require the United States to have a fairly significant military capability in the Persian Gulf region able to intervene in certain circumstances to prevent disruptions of oil supplies. The logic of that concern moves U.S. policymakers in the direction of thinking about what is most efficient for these military contingencies. The concern with Saudi instability makes the United States somewhat more cautious in its dealings with the Saudis, since one of the factors in assessing their stability is how they manage their relationship with the United States, including the question of whether the U.S. presence in Saudi Arabia would be stabilizing or destabilizing. These two contingencies show how difficult the range of choice is going to be for policymakers: how can the United States have credible military capability without building it excessively on rather weak political structures on the Arab side of the Gulf?

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The Iran-Iraq War

With respect to the Iran-Iraq war, the Iraqis may try to break out of the stalemate by threatening to escalate the war. They would hope to increase the stakes for the entire world in the Gulf conflict and thereby provoke some intervention from outside to bring the war to an end. This Iraqi "entrapment strategy" could set off a phase of escalation that would cause such a strong Iranian reaction that the United States and its allies would be obliged to go in and do something against Iranian interests to prevent the disruption of oil supplies.

The escalation might be triggered by a successful strike on Iranian oil facilities at Kharg Island which would result in an extensive and prolonged disruption of oil exports from the Iranians. If the Iranians were unable to export oil from the Gulf, they would try to make life very unpleasant for those who still were or for those who were hoping to buy oil from Gulf exporters. They might threaten to close the Strait of Hormuz or retaliate against Arab states supporting Iraq, namely Kuwait and Saudi Arabia.

Assuming that there were such an Iraqi incentive to escalate the war and an Iranian incentive to hit back somewhere against Iraq and its allies, what military problems might the United States be obliged to face? First, there is the question of the closure of the Strait of Hormuz. That would trigger, even in today's oil market, a very big crisis—one that the Western world, or even the Third World for that matter, could not be indifferent to. The oil supply disruption would be so great that it would pose a very major danger. However, as a military problem, it is not terribly difficult, although there would doubtless be costs involved, and perhaps for a period of time oil prices would go up because of uncertainty as to how long the crisis would go on. Reopening the Strait of Hormuz after an Iranian attempt to mine it or to declare that it was closed would require naval and perhaps air forces, which the United States by and large has in place.

Similarly, an Iranian threat to carry out air strikes against Saudi and Kuwaiti oil producing facilities, while one should not be too sanguine about it, is also the kind of military problem for which there are relatively clear solutions, provided the United States could make use of facilities in the threatened countries.

The real danger on the military front comes not so much from the threat to close the Strait of Hormuz or the threat by the Iranians to strike at Saudi or Kuwaiti targets, but rather from the possibility that the Iranians could, in fact, make a breakthrough on the ground in southern Iraq around Basra. Were Iran to succeed, it would have a very large ground army poised on the Kuwaiti border. At that point, the means that the United States has most readily available—air power and naval power—

would not really be very effective militarily. The United States would have to face the terrible dilemma of deciding whether or not to send ground troops in great enough numbers to deal with the threat. The prospect of an Iranian breakthrough in the ground war frightens the Gulf countries and it is the main reason that they are prepared to pay several billion dollars a year to keep the Iraqi ground forces reasonably well equipped and fighting.

In straight military terms the Iraqis are probably strong enough to avoid this collapse, but there are political considerations too. There may be the danger of a political collapse brought about because the Iraqi military, for one reason or another, simply concludes that the battle is no longer worth it or that it needs to withdraw from the southern regions to protect the region around Baghdad. These dangers may sound far-fetched, but it is not necessary to delve too deeply into recent Middle East history to see that not all military battles are determined by military balances. Politics do enter in, and if there were some kind of a political collapse in Baghdad, before too long there might be a significant Iranian ground presence in southern Iraq.

What would the Iranians do with such a position of power? They would not necessarily feel the need to march south, but they would nonetheless be in a very strong position to begin to dictate terms to the smaller Arab Gulf states. At a minimum, they could probably insure that the oil that flowed from the Gulf did so on terms set by Iran regarding shares of the market. In recent times, the Iranians have always sought a large market share primarily at the expense of Saudi Arabia, whom they accuse of garnering too much of the world market for itself and keeping prices too low.

Loss of Stability in Saudi Arabia

Saudi instability is the other kind of scenario in the Gulf that could threaten very large-scale disruptions of oil supplies. A replay of the Iranian revolution, with all the appropriate adjustments for the Saudi context, could result in a prolonged period of uncertainty, the departure of foreign oil-field workers, a drop in production over some period of time before recovery, and in the process, perhaps a loss of significant amounts of recoverable capacity or spare capacity in the Saudi oil fields, if there was a prolonged period of disarray and chaos.

Fortunately, in the Saudi case, there are no indications of an Iranian-style upheaval in the making. However, there are all kinds of weaknesses in both political and societal structures. Saudi Arabia has undergone a very rapid transformation economically and socially, but it

has not adjusted politically as much as it has in other areas. Increasingly one hears Saudis talking about the need for change in the political system.

One of the problems that the regime has had to handle is its relationship with the United States. For a number of reasons—the Iran-Iraq war, a potential Soviet threat, the threat of an Iranian breakthrough in the war with Iraq—the Saudis need to know that the United States is nearby with significant military capabilities, and that America has the will and the intelligence to use them to prevent a decisive change in the balance of power in the area. At the same time, however, Saudi Arabia does not want to be closely identified with a major build-up of American military strength on its own territory. In today's Middle East, it is not good politics to be closely identified with American military policy. Since the withdrawal of U.S. forces from Lebanon, it is not even credible to argue that a regime which banks heavily on the United States can count on its support if the going gets rough. And Iran stands as an example of the dangers of being too closely identified with the United States.

Therefore, the Saudis are still very ambivalent about the kind of American presence they want, and by and large the United States should respect their judgement on this. They know more about their own society and their own political dynamics than we do. If they think that it would overload the system for the United States to build large military facilities in Saudi Arabia, we have to take that quite seriously.

The U.S. Dilemma

So the United States faces a dilemma: on the one hand we need to have military capabilities to counter the kinds of scenarios I have outlined; on the other, building up the required military facilities puts us in the position of needing a degree of collaboration with the Saudis that in the end could prove to be dangerously destabilizing.

It is up to U.S. policymakers to sort out such dilemmas. As they struggle, they should be looking for ways to make the dilemma less acute. First, during this period of considerable spare oil capacity around the world, the United States should be encouraging the diversification of outlets for oil exports outside of the Persian Gulf region. In the immediate vicinity of the Gulf, there are several proposed projects to build pipelines that would ultimately end up putting oil out in the Red Sea. There is a good argument to be made for encouraging these developments, whether the Iraqi pipeline to Aqaba or the Iraqi pipeline down to the Saudi petroline, or other variations of Iraqi pipelines out to Turkey. All of those projects are strategically worthy of consideration, although it is unclear exactly which ones will prove to be politically and economically cost

effective. But breaking the stranglehold that the Strait of Hormuz has on oil exports is obviously worth doing.

Second, the United States still needs to pay very special attention to Saudi Arabia. It alone has enough spare oil capacity theoretically to get us through supply disruptions more readily than any other single source, assuming the Strait of Hormuz is not closed and Saudi producing facilities are not damaged. The Saudis still have over five million barrels per day of spare capacity; if they can be encouraged to keep open the option of pushing some of it out through the Red Sea, so much the better.

Finally, the United States should seize any reasonable opportunity to help bring the Iran-Iraq war to an end. In 1983 serious American officials were saying that the Iran-Iraq war was really not such a bad thing: it was weakening the two big powers of the Persian Gulf—they were neutralizing one another; it gave America's friends in the Gulf reason to think that their relations with us were terribly important; and it reduced their irritation with our Arab-Israeli policy because they recognized their need for our help to confront the Iran-Iraq war. Such notions were misguided even at the time, but now it is much clearer that the continuation of the Iran-Iraq war is likely to be detrimental not only to U.S. economic interests but also to our strategic and political interests. I am not sure what the United States can do to bring this war to an end. Perhaps it is beyond our reach at this point, but at least we should not indulge in the illusion that somehow it is good for the United States to see the war go on indefinitely.

The Iran-Iraq War: A Way Out—*Lucian Pugliaresi*

Although the U.S. capability to deal with the energy problem has improved, we must make a long-term commitment to address the fundamental energy security issues. We must do this because most of the world's low-cost oil reserves are concentrated in an unstable part of the world. This concentration of low-cost reserves among a few producers in the Persian Gulf permits those producers to get higher prices in the world oil market than they would if those reserves were spread around more broadly. It also means that the world oil market will continue to depend on the Gulf producers for oil supplies far into the future. As a result, we will remain vulnerable to economic losses from interruptions in supply.

Our near-term concern, however, is the Iran-Iraq war and the

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potential for Iran to dominate the region. In discussions with officials from Saudi Arabia and the Gulf sheikdoms, I found to my surprise that the Arab-Israeli issue was not the number one topic. The Iran-Iraq war and Arab efforts to try to contain it are now the primary concerns of these officials. Unfortunately, the general impression is that any settlement between Iran and Iraq seems a long way off.

The Gulf countries continue to maintain diplomatic relations with both Iran and Iraq. Nevertheless concern over the destabilizing influence of Iran is high. Tehran broadcasts propaganda to the Iranian populations among the smaller Gulf states telling them to overthrow their leaders. The dilemma for the United States is whether any effort we may undertake to bolster Iraq now will prevent us from establishing a relationship with a more moderate Iran sometime in the future. I suspect not, but it depends somewhat on how we carry out our emerging relationship with Iraq.

One strategy the United States might explore is to bolster Iraq's capability to sustain a war of attrition. This can be done if Iraq can improve its income sufficiently to change Iranian calculations on the usefulness of continuing the war. In addition, if the Iraqis believed that they could survive economically that might also restrain both of the warring parties from engaging in the more high-risk strategies that could interrupt oil supplies. This would serve U.S. interests by contributing to containment of the war in the upper Gulf. Right now Iraq's primary problem is that it has only limited access to markets for its oil. It is moving about 900,000 barrels a day through Turkey, but its traditional outlet through Syria is blocked and, for all practical purposes, moving oil through the Gulf is blocked.

Alternatives for Increasing Iraq's Access to World Oil Markets

Iraq could increase its oil exports if new pipelines were constructed. One route that looks promising would be a route from Iraq through Jordan to the Gulf of Aqaba. Another possibility would be to double the capacity of the line through Turkey. Another might be to move oil farther down the Gulf, perhaps to the Saudi petroline and then out to the Red Sea through an existing pipeline. All of these alternatives would provide significant improvements in Iraqi income, but perhaps not soon enough. Iraq was able to roll over much of its debt in 1983, but it still suffers from severe economic problems. Its debt structure is large, but compared with the size of Latin American debts, not unmanageable.

Iraq must change outside expectations of its ability to survive. These new pipeline routes would improve Iraq's economic prospects. We

have found it very difficult to understand why the Iraqis have not moved sooner and more quickly. Perhaps the Iraqis fear that proceeding with any of these pipeline projects will prove uneconomic as soon as the war ends. That fear makes them wait another six months, another year, hoping the war will end. But it is equally likely that it may last much longer.

At this time, the project the Iraqis have shown the most interest in is the spur line connecting to the Saudi petroline. However, the Saudis will probably find that having to deal with Iraqi crude oil crossing sovereign Saudi territory will raise political problems for them. In the end they may not approve the project quickly enough to get the spur built. It is a difficult dilemma for the Saudis. On the one hand, they could provide the Iraqis with a great deal of assistance. The existing pipeline to the Red Sea has well over a million barrels of excess capacity. The spur could be built in a little over a year if construction began right away. But once the scheme got underway, the Saudis would be in the position of regulating the Iraqis, possibly having to tell the Iraqis to cut back when they begin to violate their OPEC quota or undermine world oil prices. That is something the Saudis historically have not liked to do. The Saudis generally like to deal with their neighbors in a more subtle manner. In addition, they could be accused by many of their fellow producers both in and outside the Gulf of acquiescing in irresponsible behavior on the part of Iraq and permitting Iraq to undermine the OPEC price structure. However, events in the Gulf are unpredictable and it is just possible that the Iraqis and Saudis may make the spur connection work.

The route to Aqaba appears to offer Iraq more flexibility than a pipeline through Jordan. This route allows Iraq to move oil directly to the Red Sea through the port of Aqaba. The oil crosses Jordan, which is not an OPEC producer and whose interests are largely in getting transit revenues and a new source of oil. Also, from the U.S. point of view, use of the Aqaba route increases the volume of oil which can move to market in an emergency, whereas the spur line does not increase the total capacity that could move in an emergency.

One of the major concerns that has been raised in the past about the Aqaba route is that the oil would pass close to Israel. In my view that is not a real issue for the Iraqis or the Jordanians. Iraqi concerns could be addressed with some sort of U.S. private sector presence in the project—perhaps a prime contractor or some U.S. operating entity in the region. Finally, proximity is not the central issue, the Israelis have shown they are capable of taking out targets as far away as Baghdad.

For the United States all of the above concerns must be weighed as we assess what role, if any, we ought to play to bolster Iraq's capablity to sustain a war of attrition.

Part Two

International Banking in the Wake of the Debt Crisis

1.

Introduction

Paul H. Boeker

In the 1970s commercial bank lending was providing about two-thirds of the net external capital flows to Latin America—to use that region as an example. That affected the North-South financial pattern in specific ways and in the end brought its own set of problems. This high level of lending involved costs in terms of debt servicing and raised questions about the stability or sustainability of that rich a mix of commercial bank lending to those kinds of countries. It also had an effect on domestic policy performance and the use to which the funds were put. In particular, this flow of capital gave a great deal of flexibility to central governments and monetary authorities in the use of that balance of payments financing.

In the last couple of years there has been a dramatically different pattern of North-South lending, one in which limits on the sustainability and the debt servicing ability of borrowers have resulted in a dramatic drop in the role of commercial bank lending. That drop in turn has had some dramatic effects in the hemisphere. It has caused a very painful retrenchment in the economies of the borrowing countries. Official lenders have had the difficult task of reappraising their role and have been forced to make a lot of instant decisions about what should be done in some emergency financial rescues.

We are now faced with the questions of what the desirable, stable, and optimum pattern of North-South financing should be for the longer-term future and what the proper role is for commercial bank financing in that mix. This symposium will concentrate on these questions and try to paint a picture of what an efficient, sustainable pattern of North-South lending and commercial bank involvement might be in the 1990s. The picture must include interests of borrowers, banks, and stockholders in the

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international financial system, as well as those poor governments that stand around and take up the slack.

The role of commercial banks cannot be discussed in isolation. It is also vital to discuss what the international financial institutions should be doing and what bilateral government assistance should be extended and to whom. Obviously the answers will be different for Bolivia than for Brazil.

2.

Prospects for Lending to LCDs: Bankers' Views

The Investment Banking Strategy—*Laurence J. Brainard*

There is a tremendous amount of diversity among banks and how they define their strategic goals and their overall strategy. Bankers Trust, the bank I work for, took a decision some years ago to combine traditional commercial banking with what goes under the rubric of investment banking. This decision had a number of implications for international lending.

The important element in investment banking is that the bank is seeking to provide financial services in a way in which it does not end up holding the asset for a long period of time. The bank makes a loan with the purpose of distributing or selling the loan to other investors. It is similar to what investment banks do when they arrange financing without actually ending up at the end of the day with a piece of paper.

Traditional strategies used during the 1970s were ones in which banks made loans and earned their rate of return from the spread between the rate on the loan and their cost of funding. Bankers Trust strategy today is to make money, not from this net interest margin, the margin between the interest charged on loans and the cost in getting those funds, but rather the bank wants to make its money in financial services. It originates loans, takes a fee, sells the loans, and takes another fee. But it does not have that loan on its books.

This way of conducting business implies a shift in focus from an interest in size of the balance sheet to an interest in profitability. Bankers Trust is not that concerned how large it is, but it is concerned about its rate of return on equity.

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Following this strategy, if a bank is going to make loans to countries with the intention of reselling those loans, there has to be an investor out there who will buy the paper. The question, therefore, is whether or not Bankers Trust—and other banks using the same strategy—will originate a lot of loans to less-developed countries (LDCs). The answer is simple. If there are people who are willing to buy these loans, Bankers Trust certainly will. But if there are no investors out there willing to hold this paper, no bank is going to be lending to LDCs unless it is forced to do so.

Therefore in trying to gauge the impact of this strategy on the longer-term flow of capital, one has to find out how acceptable LDC paper will be in the marketplace. To do that one has to differentiate carefully among developing countries.

Certain developing countries have been very successful in taking in balance-of-payments loans and putting them to productive use. It is interesting that most of these countries are located in Asia; premier among them is Korea, which has a debt service ratio of just under 20 percent. Although its total debt is close to $40 billion, its exports are almost that high, indicating that there is a very solid cash flow underlying this debt. In the future Bankers Trust will continue to lend to Korea on a balance-of-payments basis, because it is our judgement that there will be a continuing interest in Korean paper. Likewise, the major OECD (Organization for Economic Cooperation and Development) countries and the LDCs that have been able to develop their export markets are countries in which Bankers Trust will continue to be active.

In other countries, the situation is completely different. Between Korea and most Latin American countries, there is a world of difference in the size of exports and T/SAsize of debt and the level of debt servicing as a percent of total foreign exchange earnings. In fact, most projections, even those based on optimistic assumptions, are that in five to seven years Latin American countries could be back into a situation similar to the one they were in in the early 1980s. In any case, these countries do not meet Bankers Trust's criteria for loan recipients, and it is probable that there will be few investors who are interested in purchasing Mexican, Brazilian, Bolivian, or Costa Rican paper in the future.

The strategy differs for different geographical areas and for different countries. A number of countries can only be described as basket cases: Bolivia, Zaire, Sudan, and probably Costa Rica. Other countries, such as the Philippines, are perhaps on the edge. For these countries commercial lending is not in prospect. They must look for foreign aid and humanitarian assistance. A number of other countries, Mexico and Brazil among them, are and will remain critical because they have a viable domestic

economy and a substantial infrastructure and industry. However, I do not see voluntary lending coming back soon to these countries, at least not in the next three to five years.

In the future, the American continent south of the Rio Grande is going to be treated as an exception from the rest of the world. To be sure, perhaps the Philippines should also be included along with some African countries. But Africa has depended primarily upon trade financing and official flows, not commercial bank flows. There is, however, a concentration of economic problems in Latin America and they are related to sensitive political and social issues.

The U.S. government strategy up to now has been to allow commercial markets to work out the solution. In today's environment and given the kinds of forecasts that we have for the future, I find it rather unlikely that there will be a market-type solution. What's more, our government has no overall strategy to solving the Latin American debt problem. This lack of direction has put tremendous pressure on many banks, particularly the money center banks, and could eventually have serious repercussions.

Lending: Voluntary and Involuntary—*William D. Klay*

Today the near-term lending activities of banks which make loans to LDCs are focusing their activities on restructuring existing loans. Over 30 countries in Africa, Latin America, and Eastern Europe are being forced into such restructurings. The commercial banks are at present involved in restructuring 1983 and 1984 maturities in their portfolio. It is fairly certain, however, that many countries which have had these maturities restructured will be forced to have 1985 maturities restructured as well. This will not be done until 1984 economic reports are out because the banks structure the transactions so that the payment plan of a country and the debt structure that is proposed are in accordance with the economic realities of the country's economy.

As a result of this process, banks are going to make greater and greater distinctions among countries. Those which have gone into International Monetary Fund (IMF) programs which are starting to work and which are building the future debt capacity will be favored by the banks.

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Countries which have not exhibited the political will to put their economic house in order or which do not have the economic resources to turn themselves around as quickly will not be courted.

Most term lending, particularly large balance-of-payments loans to LDCs, will continue to be "involuntary," i.e., banks will be forced to provide the funds necessary to fund the financial gap in a borrowing country's balance-of-payments deficit. Almost without exception, banks deal very closely with the IMF in putting these financing arrangements together. Because no bank would lend to these countries voluntarily, banks have to rely on the IMF country plan to build the debt capacity required to service the debt.

Voluntary lending in the near term is extremely limited and quite changed from what was being done in the 1970s. Today the most hotly pursued transactions by the commercial banks are the guaranteed credits of the Export-Import Bank and the Commodity Credit Corporation. Similarly, transactions by any prime external guarantor are considered attractive.

Trade is the cornerstone of all international finance and is the first voluntary financing with no external guarantee that can be expected in countries. Trade packages are frequently a part of the restructuring packages because banks recognize that if trade money dries up, countries are going to be in a less satisfatory condition than they are today. Many countries which have been forced to restructure term obligations still have access—albeit restricted—to trade financing.

World Bank co-financings are also attracting attention. There is a greater risk than in guaranteed credits because co-financings are not guaranteed transactions. However, they are one means many bankers would use to finance viable transactions in countries which have had debt problems.

Project financings are also an increasing focus of attention. However, they are always extremely complex and detailed and have to be tightly controlled. Project financings of particular interest are those that generate foreign exchange—for example, a mine which will export a commodity that generates foreign exchange.

The level of financing to LDCs has been significantly reduced. Bank capital did not grow as rapidly as loans to the LDCs grew, and a very high percentage of capital is already in LDC borrowers. Consequently, significant increases in lending to those countries is limited by capital constraints, legal lending limits, and so forth.

In conclusion, LDCs themselves are working to build their debt capacity, but their current capacity is significantly limited. On the basis of their own economies, one cannot justify direct financing in any near-

term time frame. In the long term, however, I am optimistic that the process is working. The system has changed dramatically in the last two years, but it is changing in a very positive way.

The Viewpoint of Regional Banks—*Charles T. Owen*

To understand what the future of the regional banks will be in international lending, one must look at why they initially went into the business.

There is a group of regional banks which has traditionally been involved in international lending. Some are very large institutions; however, some middle-sized and smaller regional banks have had a long-term role in the marketplace today. Many initially became involved in international lending in order to protect their domestic customer relationships. These customers had the opportunity to make international sales, and, if the regional banks had failed to support those opportunities overseas, the banks would have lost the relationship. These customers would have gone to money center banks for support in their international sales effort.

Other reasons are also valid. Many institutions wished to grow—to increase their asset base and earnings—at a rate in excess of what they could do in their own region or area. There is also a certain prestige among regional banks in having an international banking division.

My own institution, the First National Bank of Louisville, became involved internationally simply to protect its domestic customer relationships. We felt it was important for the bank to have a strong international lending capability; however, we knew we could never develop the volume of business of a money center bank. We decided not to place offices or personnel overseas but to limit ourselves to traveling on occasion and to develop very strong correspondent banking relationships with selected banks in individual countries.

Our focus was primarily upon short-term and trade-related business in those countries. In 1982, prior to the debt crisis, 80 percent of our

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portfolio was in Latin American short-term, trade-related loans. Only 10 percent of the portfolio went to the private sector, and this was to the subsidiaries or affiliates or major distributors of our best domestic customers. The remaining 10 percent went to public sector entities. This final category did not represent balance-of-payments lending but lending to government agencies. A good example is a loan made by the bank to finance the exportation of hotel supplies to Venezuela by a major U.S. hotel chain and which was guaranteed by the government of Venezuela. In order to establish credibility in that country and to prove our support for the economy, we made this loan. This loan also helped us to develop a relationship with one of the leading correspondent banks in that country.

Today our portfolio is long-term and it is solely to the public sector. Because of restructuring agreements, we have been forced to shift completely away from the sector in which we attempted to lend two years ago. Our bank no longer makes loans to privately-owned commercial banks in Latin America. This turnaround will greatly affect the direction our bank will take in the future.

As lenders, we lost control of our portfolio in international lending. Currently there is no end to involuntary or forced lending. Some countries are already predicting they will need new funds from the commercial banks through 1988 and possibly into 1989. Again, that is assuming the situation continues to stabilize and in some cases to improve as it is right now.

For all of us the most realistic objective is to be able to return to voluntary lending. In the future, if the situation stabilizes, regional banks, particularly those that got into the international market recently—in the 1960s and 1970s—will operate only in very select countries. We will studiously avoid the basket-case countries. We will continue to lend to countries such as Mexico or Brazil, where we have long-term strategic interests, as long as those countries continue to abide by the agreements that are in place today or will be negotiated in the near future. However, there are a number of countries which have done irreparable damage to their image among creditors. They will find it very, very difficult to obtain voluntary loans in the future. We will deal only with very select banking corporations in each of these countries.

Regional banks may possibly limit those lines of voluntary credit that have been provided for trade to geographical areas within the United States. For example, I might approve a letter of credit for a beneficiary in a given geographic area of the United States only if the beneficiary is a customer or prospect of mine. Many banks will obviously demand Ex-Im or similar guarantees. There will be very little or no interest whatsoever in balance-of-payment financing or project financing. Finally, there are

very limited prospects for the foreign private sector—specifically those corporations in foreign countries that previously borrowed in dollars will be very restricted.

Many of my colleagues who were formerly assigned to Latin American lending in the regional banks have moved over to the domestic side of their banks. It is a lot safer there right now. One does not have to wonder what is going to happen in Venezuela in the next six months. This is unfortunate because a great many people who are experienced in Latin America and other parts of the world no longer wish to be actively involved in lending there.

The Need for a New International Banking Structure
—Charles F. Meissner

Banks are involved in many activities. One is accumulating capital and lending it to developing countries. That is, banks are capital exporters. Whether a bank operates as a merchant of financial services or as a commercial bank in the traditional sense, in essence it is collecting money either from depositors or investors, packaging it, and selling it. Actually, the process usually operates in reverse. A banker gets a demand from a customer and then tries to package the supply for the demand.

In the developing world commercial banks lend to only about fifteen countries at the most, and these countries are advanced developing countries. Commercial banks cannot lend to poor countries because such countries cannot pay commercial interest rates. The very poor LDCs are serviced primarily by multilateral agency soft windows and bilateral loans. A mix of transitional countries borrow from multilateral development agency hard windows and obtain some International Development Association and regional soft money, mixed with trade credits from the commercial sector or perhaps some slightly longer-term money from the private commercial sector. Only for countries such as Mexico, Brazil, Argentina, Venezuela, Korea, Taiwan, Hong Kong, Singapore, and a few Gulf coun-

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tries is secured lending possible. In addition, a few countries on the southern shore of the Mediterranean have the capability of borrowing commercially because of their petro dollars.

In turn, the number of banks exposed with large sums of money abroad is also small. In the U.S. banking system, the top nine banks have 60 percent of the cross-border exposure to developing countries, and the top twenty-four banks have about 80 percent. These are the capital exporters, but they are not exporting anymore. Only in the context of an IMF agreement or of involuntary lending is any money moving at all into the advanced developing countries.

Advanced developing countries include the southern tier of Europe—Portugal, Spain, Greece, and Turkey—where there will be continued lending assuming that the Turks continue to perform. They were in a rescheduling in 1978 and 1979. Eastern European countries are also in the advanced-developing-country category: Yugoslavia, which is in a restructuring; Hungary, which is sitting on the fence but probably will make it; and of course Poland and Romania, both in restructurings.

In Eastern Europe East-West considerations greatly affect the whole ambience of economic intercourse. The one exception is Yugoslavia, although the international banking community, which is not too sophisticated in such matters, may fail to differentiate betwen Yugoslavia and the other Eastern European Warsaw Pact members.

The first petro dollar recycling in 1973 and 1974 was a major mistake that will not be repeated. At that time a significant expansion in sovereign lending was needed. It should have been done primarily through the IMF. Instead the oil facility was used, but it did not have the financial base to put together programs for recycling petro dollars. The finance ministries did not attempt to put together an effective structure internationally to recycle funds to sustain sovereign lending, and the only effort that was made in that area was a financial safety net for the OECD to "help negotiate" the oil situation with OPEC (Organization of Petroleum Exporting Countries). That never passed the U.S. Senate. Therefore, by default the banks were encouraged to recycle funds, and they did so massively. In 1973-74 they increased their lending to the developing countries by 49 percent. The same type of thing happened in 1978-79 with the oil price increase and about a 35 percent increase in lending to help finance that petro-dollar recycling problem. Banks were providing funds for balance-of-payments support and changing the financial and debt profile of developing countries, and they were doing this without conditionality. In the debt reschedulings which began in 1981 with Poland and then in 1982 with Mexico, banks continued to lend for balance-of-payments purposes, but on the basis of conditionality.

That sort of "gung ho-Wild West" banking of the 1970s is past. Such massive capital flows will not be seen again, and it would not be appropriate to ask the international banking sector to once again play the role it played in 1973-74 and 1978-79. Therefore, the issue is how to implement new structures of international lending, especially to the advanced developing countries that have capital absorption capability to use funds effectively to grow. How can a long-term institutional structure be set up to stabilize international finance and support economic development in the advanced developing countries? The advanced developing countries I listed will remain in the "developing" category probably until the middle of the 1990s. By that time they should be integrated into the OECD trade and finance system. But from 1995 on there will be another group of ten or fifteen countries that will be called advanced developing countries, and they will be going through the same capital importing process.

The broader issue of debt should be looked at in the context of the international economy. We are facing a significant period of international financial and economic disequilibrium. The massive U.S. federal deficits are part of it. High nominal and real interest rates are part of it. So is the overvalued dollar. The United States, as the largest international capital base in the world, is importing capital. That situation is not sustainable. There is a lack of coherent and coordinated economic growth in the OECD. None of these issues is being addressed.

The Administration's commitment is not to multilateral economic policies that would promote stability and expanded development. Instead the United States is working primarily to stabilize the U.S. financial system. For example, only in cases where countries have been perceived to have a systemic importance to the stability of the American banking systems or are judged to be vital to U.S. security interests has the United States been ready to provide emergency finance.

We need a solution to the debt problem that ties together what the governments do, what the debtor countries do, and what the banks do. Banks will probably have to put caps on interest rates on restructured money because U.S. fiscal and monetary policies are irresponsible. Restructurings will involve longer grace periods and longer terms; fees will probably have to be eliminated. Most important, banks will have to work with international and national institutions to set up a new structure to sustain international banking. Today banks cannot go to the U.S. Congress for any new money or any guarantees, so that means they will initially have to come up with the necessary capital to set up an "international reserve bank" which would loan in parallel with the IMF and the World Bank. If possible such an "international reserve bank" could work out arrangements to help support other central banks when they need money.

If it were successful, it, like all central banking functions, would eventually be bought out by the governments once they see its value.

In Spite of Problems, Banks Will Continue to Lend

Banks will continue to lend to developing countries, at least to those that appear willing and able to met their repayment commitments on time. Banks are still making energy, real estate, and shipping loans—despite all the problems they have had in the past—and over the long run they will also continue to make loans to developing countries. In fact, banks are still making additional loans to many. During 1983, international bank credit to Indonesia rose 22 percent; to the People's Republic of China, 15 percent; to Egypt, 18 percent; to Malaysia, 22 percent. These, and a lot of other developing countries are still getting new loans, including some that have had debt problems in the past.

One hopes, both for the sake of the banks and of the developing countries, that we do not go through a period of excessive growth in short-term bank lending, as we did in the late 1970s and early 1980s. Much of this lending did not finance development-investment or even current consumption. As much as a third of it financed capital flight, investments abroad by residents of the borrowing countries themselves. Both the countries and the banks now recognize these past mistakes, but new banks, new bankers, new countries, and new governments are constantly emerging, so particular problems of "underlending" today should not blind us to the ongoing possibilities for "overlending."

There is also the question of getting paid back. Banks do lend under this "illusion" and should continue to do so. I lend under this illusion; most of us do. When I go to my bank, I expect my money to be there when the deposit comes due. I expect repayment on my U.S. Treasury bill when it comes due. I know the government debt will not be paid off, but I do expect to get my own payment on time. Banks should be making loans to developing countries under the same kinds of illusions, but it should be up to the borrowing country, not the banks, to create them. The IMF has a critical role here, not so much for the money it provides, but for its advice and judgement. The IMF may well need additional support, more funding from creditor governments, and more cooperation from debtor governments if it is to effectively help recreate and sustain these illusions.

William Gasser

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3.

How the International Financial Institutions See The Role of Commercial Financing

The IMF: Changes Required to Restore Voluntary Lending
—Eduard Brau

What changes must be made for voluntary lending to take place again? The first change is obvious: the lenders need creditworthy borrowers. The second change is to emphasize trade financing and move away from balance-of-payments financing.

In the phase of debt accumulation, lenders have a surprising lack of control over the borrowing countries' policies. A single borrowing country may be borrowing from several hundred different commercial banks, in addition to governments and multilateral institutions. They may all think the additional marginal loan is not going to make a difference. If many lenders think this, clearly there is a weakness in the system due to a fallacy of composition. It is probably impossible for commercial lenders to encourage borrowing countries to be more prudent because the lenders are in competition.

This problem of competition among lenders also means that borrowing countries initially tend to borrow more when they encounter a balance-of-payments problem, rather than approach the IMF for support of an economic adjustment program at an early time when the degrees of freedom are many and the adjustment is relatively marginal and not traumatic.

To solve this problem the borrowers themselves have to exercise better control. Lenders, in particular government lenders, should encourage borrowing countries to define clearly what volume type of external borrowing they want to do in the next three or four years and for what broad purpose. In other words, borrowers should define an external debt

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The International Monetary Fund

The IMF was created at the Bretton-Woods Conference in 1944. Its purpose was to promote international monetary cooperation, to facilitate the expansion of international trade, and to promote stability in foreign exchange. One-hundred and forty-nine nations belong to the IMF. (The U.S.S.R. and Eastern Europe do not belong.) Members are pledged to orderly exchange agreements. Operating funds are subscribed by member countries according to a formula based on the volume of international trade, national income, and international reserve holdings. If members have temporary difficulties with balance of payments, they may purchase from the IMF the currency they need. Because of the increasing volume of international transactions and successive financial crises, in 1969 Special Drawing Rights were devised to provide additional reserves that could be used to settle international imbalances. Special Drawing Rights effectively increased the amount countries could purchase from the IMF without increasing their contribution to the Fund. In 1973, the fixed-exchange-rate system that had been established by the Fund collapsed as many countries chose to float their currencies. After a three-year effort to reach an agreement on a new international financial structure, in 1976 the IMF Board of Governors revised the IMF charter to allow floating currency rates as the standard for the world currency system.

policy set in a medium-term context and not regard external borrowing as a residual in their macroeconomic planning. Thailand has done this by legislation and Korea by practice. If the anticipated recourse to external borrowing is exceeded because the current account develops differently than anticipated, then adjustment policies are adopted. This means that all lenders can judge the debtor's actual performance over time against the standard which the debtor has itself set.

When a borrowing country's economy is mismanaged or when unforeseen external conditions affect a country's ability to service its debts, a rescue operation becomes necessary, to be carried out on a case-by-case basis. For certain countries the time has come to provide more flexibility to lenders, particularly to commercial banks, for trade financing. The new money that is being provided by banks to countries needing special assistance typically is provided as a loan to the government. It would be helpful increasingly to include provisions under which part of these funds might be used to restore private sector trade financing lines.

In designing rescue packages, certain issues should be got out of the way. For example, restructuring debt service on pre-1982 debts probably should be done in a longer time frame with terms realistically adjust-

ed to the debtor's capacity to service the debt. No lender is under the illusion that there will be a net repayment of principal any time soon—that is a non-issue.

It is clear that any durable solution to the debt servicing difficulties has to be growth oriented. Countries cannot sustain prolonged domestic recession. Both debtor and creditor countries have an obvious interest in growth in the debtor countries. Normally, a growth-oriented strategy means that developing countries need to borrow more. The big question is, for what? Lenders are not now readily prepared for more lending to developing countries. They want more assurance; they are asking the debtors to tell them what their high priority financing requirements are. It should be feasible for certain debtor governments to work out, say, a three-year public sector investment program and request a review by the World Bank. Then the government could present a World-Bank appraised investment program to lenders for financing.

In restoring trade finance and gradually encouraging the resumption of voluntary lending by commercial lenders, official export credit agencies have a special catalytic role. Given the accumulated external debt levels and generally heightened international credit risk, the demand for insurance on trade credits provided by commercial lenders has risen and is bound to stay high over the next few years. Export credit agencies could play a valuable bridging function by providing the insurance sought by lenders in the case of borrowing countries making adequate efforts to restore their creditworthiness.

The World Bank: Restoring Balance—A Task for Both Debtor and Creditor—*D. Joseph Wood*

Over a long period of time in the 1970s the exposure of commercial banks to the major developing countries rose at roughly 20 percent per annum. Currently it is rising at a much slower rate, more on the order of 6 or 7 percent per annum, and that lower growth rate in exposure is expected to continue.

Why is this growth rate now so much lower? There are two simple reasons. First, the borrowing countries have to restore a balance between their debt servicing capacity and their debt. Given their prospects for growth in exports, which is the driving element behind the debt-servicing capacity, their debt, which is the lender's exposure, must grow much more slowly than the 20 percent of the past. Second, the lending institutions too have to restore some balance. That means allowing their exposure to

The World Bank

The World Bank is also known as the International Bank for Reconstruction and Development or IBRD. It was established in 1945 to deal with post-World War II reconstruction in Europe. Since that time its aim has been primarily to assist with economic development in member nations by making loans in cases where private capital is not available. The International Finance Corporation, which aids LDC members by promoting private enterprises in their economies, and the International Development Association, which extends credit on easier terms to the poorest nations, are both affiliates of the World Bank.

heavily indebted countries to grow less rapidly than their portfolios as a whole or their capital base so that over time they will restore the balance.

The question is what the growth rate will be. If the growth rate is lower than the interest due on outstanding debt, then the creditors are getting partial repayment of the interest due. The debtors are also getting something—partial financing of new funds to cover the interest burden. At issue is how this balance will be struck between creditors and debtors in the future.

In 1983, in the major Latin American countries the balance was struck in such a way that the debtor countries realized current account surpluses, excluding interest payments, sufficient to cover almost 85 percent of the interest payments due. This average, like most averages, conceals major differences among countries, but nevertheless it shows the extent to which the debtor countries have made an adjustment effort. In the two years up to 1983, the imports of major Latin American countries were cut in half; they suffered the sharpest decline in output and employment in fifty years. The changes were comparable for many of these countries to what occurred in the depression of the 1930s. In terms of output, the level achieved in 1983 was roughly a third below what would have been achieved if the trends of the 1970s had continued. In other words, the balance that was struck in 1983 was achieved only with very considerable adjustment and pain on the part of the debtor countries.

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For the future, the official strategy is based on a number of assumptions. The first is that growth in the industrial countries will proceed at a rate on the order of 3 percent plus. Others are that protectionist tendencies will be resisted sufficiently to permit less-developed-country exports to grow at a somewhat more rapid rate, that real interest rates will come down from the recent highs, and that the discipline that the borrowing countries showed in the recent past will be sustained.

This strategy has implications for borrowing countries. For example, for the Latin American countries it implies a resumption of per capita growth, particularly in the latter years of the decade. But the growth projected will permit these countries to restore by the end of the decade only the levels of per capita consumption which they had when the decade opened in 1980. So while it is a scenario of progress for them, it is progress from a reduced base.

From the bankers' point of view, this official scenario assumes growth in their own exposure much below historical averages. If all of these assumptions hold, the balance between debt-servicing capacity and debt will substantially improve. One measure of that is the relation of debt to exports for Latin American countries. Where the ratio of debt to exports was 3.4:1 in 1983, by the end of the decade it will be reduced to about 2:1.

There is no doubt at all that the realization of this official scenario implies major tests of the social and political framework in borrowing countries. They have political cycles not unknown in this country, and those political cycles will all be run through a period of extreme tension before the end of the decade. What I mentioned in dry economic terms about the borrowing countries generating a sufficient surplus to pay back a substantial share of interest is capable of being put in a much more inflammatory way by people who have a political point to make.

For the borrowing countries it is essential that the major reductions—particularly in imports—that the crisis forced them to enact, must be replaced by policies and programs which have a growth orientation, and that does not happen of its own accord. It is a difficult, complicated process of institutional and policy change.

The official strategy, particularly in Latin American countries, will depend on a resumption of activity by both the domestic and the foreign private sector. Given the travails of the private sector's experience in these countries, one cannot assume this will happen automatically and without support.

What does that imply for official capital? First, it is not only important, it is vital that debt restructuring arrangements be seen in a medium-term perspective. Their political viability depends on whether or

The Ex-Im Bank Role in Developing Countries

The mandate of the Ex-Im Bank is to facilitate export financing that is clearly needed without competing with the private financial system. Naturally the Export-Import Bank Charter also mandates that the board shall have reasonable assurance of repayment of its loans. Starting with the 1982 Mexican announcement that it would be unable to service fully its external debt on its original schedule, the Export-Import Bank had to reassess its role and function in the developing-country market.

Basically the Ex-Im Bank views the LDC debt problem as temporary in nature. While the problem is not as short-term as we liked to believe back in 1982, neither is it necessarily an intractable long-term situation. After all, the debt took some ten years to accumulate, so why should we assume that we can eliminate it in two?

The Ex-Im Bank has thus developed a rather broad definition of "reasonable assurance of repayment," in which the possibility of reschedulings within the repayment period can be contemplated. As a result, the Ex-Im Bank is open in many countries generally in debt difficulty, including most Latin American countries.

In the near to mid-term future, the situation is not likely to change. A look at the pro-forma balance of payments of most debtor countries shows that there is a pattern of fluctuations in their debt-service ratios. One year the ratio is high. The country reschedules its debt and the debt-service ratio goes down for that year. But the next year it can go right back up again. Some of these countries will not be able to meet any reasonable growth target without having to reschedule their debts.

However, the Ex-Im Bank is willing to continue working with countries that comply with the IMF in setting up some kind of adjustment mechanism. For countries that choose not to take that route, the Ex-Im Bank has difficulty justifying that the country is indeed trying to rectify the situation so that it can offer some kind of assurance of repayment in the future.

Currently, the Ex-Im Bank has been participating mostly in what bankers call trade financing for spare parts and raw materials. Such imports are basic to the LDC economics and, in some cases, are all that is left in the import budgets of debtor countries. Imports have been halved in some of these countries, down to the essentials, and that is what we have been financing. However, it is clear that if these countries are going to achieve sustained growth in the future, project financing must be made available. Many projects essential to the process of development have been postponed or cancelled in these countries.

I believe the Ex-Im Bank will be able to provide some project financing. So far it is the only official export credit agency that has been moving aggressively in the direction of bridging the gap between commercial banks and the need for financing longer-term development.

Rita Rodriguez

not the authorities in the countries concerned are able to show their populations that the future will bring steady improvement. They have to see the light at the end of the tunnel.

Second, there is a need for a "disciplined framework" for external capital flows. When I say "disciplined framework," I am referring to the tendency for private capital flows to go through manic-depressive cycles. Private lenders in competition cannot impose discipline, and it is difficult for the borrowing countries themselves to maintain discipline unless there is a crisis or unless a link can be created between their own performance and capital flows.

Third, there is the question of contingency finance. The official strategy does not say what happens if something goes wrong. If the growth of trade is not what was hoped; if real interest rates do not decline; if performance does not measure up to high standards, what then? Where does the money come from? To illustrate this point, I will make reference to the World Bank. The Bank is currently beginning an internal discussion about its future lending capacity. In the current fiscal year the Bank expects to disburse about a billion dollars to Mexico and Brazil. Looking forward into the medium-term, if the Bank were to live within its existing capital base and the programs of these countries were to be constrained to fit within that limited lending authority, then the net financing would fall by roughly a half from the current level. On the other hand, if the Bank were to continue the acceleration of lending activity that has characterized its activities in the last couple of years, then the amount of net financing could roughly double. Neither of these two extremes is very likely; however, it is clear that what the Bank decides to do will substantially affect its capacity to provide contingency financing in the medium term. The same thing could be said about the IMF and its ability to borrow externally or about the export credit institutions. The decisions made by these various official institutions in the aggregate will make a big difference in the amount of additional finance available.

Finally there is the question of risk management and interest rate caps. From the point of view of the creditor, it is hard to manage risk with

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or without interest rate caps. If interest rates are capped, it is possible that the lending institutions will be providing an implicit subsidy, and they do not feel they are in that business. They feel that providing subsidies is the business of governments. On the other hand, if contingency arrangements provide for financing the additional interest, then the amount of debt is increased without any corresponding adjustment on the borrower's side. The Bank has implemented an alternative arrangement in which it undertakes a contingent obligation to finance increases in interest payments above an agreed level, thus providing assured financing in the event of substantially increased interest rates.

The way the mechanism works is that, as in a mortgage, a level payment is created involving both interest and principal. If interest rates increase, then the interest component of that payment increases and the principal is deferred until the end of the life of the loan. However, the World Bank takes on the obligation of financing that incremental principal so that the interest stream of the lending institution is not impaired. From the point of view of the borrowing country, there is some stability in the total payment. For that kind of arrangement to be viable on a larger scale, a number of conditions would have to be met. In particular the incremental debt would have to be associated over time with incremental adjustments so that there would be a balance between the changes in debt and changes in debt servicing.

4.

U.S. Interests and Policy Implications

A Strategy for Dealing with the Debt Crisis

—George R. Hoguet

The problem of the high-debt LDCs is serious and calls for close attention for some time. The problem is particularly important for the United States, not only because of its global economic and financial interests, but also because the problems are concentrated in Latin America. A study by the New York Federal Reserve Bank in a recent quarterly bulletin estimated that the decline in U.S. exports to Latin America has cost the U.S. economy approximately 400,000 jobs in the past couple of years.

The strategy that has been devised to deal with the debt problem has been working by and large. The key elements and a basic framework are in place. However, the strategy is clearly not a panacea and can be refined and improved as necessary. It is focused on the medium term, aims to restore countries to creditworthiness and recognizes the need for a case-by-case approach.

The strategy was first articulated in 1982 at the Williamsburg Economic Summit and later endorsed by the OECD. Although we are still going through only the early stages of adjustment, the economic environment has improved substantially since August 1982 when the debt crisis first broke with the famous "Mexican weekend." Clearly restoration of growth in the United States and lower inflation have had a positive effect on the situation.

The strategy has five key elements:

- economic adjustment by borrowers,
- global economic expansion and the avoidance of protectionist pressures,

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- continuous commercial bank lending,
- continued support for the international financial institutions, and
- temporary official bridge financing on a highly selective basis.

The debt crisis was brought on by the confluence of external and internal factors. Poor domestic economic policies, particularly in the case of Latin America, are greatly to blame. But policies can be changed and, in fact, have been changed in many instances. For example, the current account deficit of the non-OPEC LDCs dropped from roughly $100 billion in 1981 to about $50 billion in 1983. That dramatic swing took place in large part through the compression of imports; however, both in the case of Mexico and Brazil for example, there is a fairly substantial increase in imports. Mexico's imports were up 44 percent in the first quarter of 1984 over 1983.

A key to adjustment obviously is export-led growth. Resources must be shifted to the export sector. In some cases this shift of resources may have to be substantial in order for some countries to meet the interest on their debt. Naturally such growth depends upon maintaining an open international trade system.

OECD growth in 1984 was 4.9 percent. A year earlier we were predicting that it would be about 3.25 percent. The recovery in the United States is proceeding with low rates of inflation.

The U.S. trade deficit is fueling the recovery. U.S. imports from the six major Latin debtors were up $2 billion or 30 percent in the first quarter of 1984 over 1983; exports of non-OPEC LDCs were up about 40 percent in the same time period. Brazil's exports to the United States, for example, were up 50 percent in the first quarter of 1984 over 1983. There has been some rebound in commodity prices; the IMF price index now stands at about 87 versus an all-time high of about 100 in 1980, and growth is having a significant impact in terms of offsetting the impact of higher interest rates. Maintaining an open and growing world economy is a key element of addressing the debt problem.

The avoidance of protectionist pressures is also an important element in the strategy. Average tariffs on imports into the United States are only about 5 percent, although tariffs on individual products such as textiles, steel, and footwear are higher. The U.S. market is really quite open, and keeping it open will be a key element in assisting debtor countries to restore their creditworthiness.

The third element of the strategy is IMF resources. The IMF has been strengthened through the quota increase and enlarged General Authority to Borrow (GAB). Contrary to popular perception, IMF programs are pro-growth; the evidence clearly bears this out. Structural adjustment

lending by the World Bank is potentially very useful in complementing Fund programs. However, the demand for structural adjustment lending is not very high. Several countries face very severe structural problems, problems which perhaps are better dealt with by the World Bank rather than through the IMF. Again the matter is for the countries to come to the Bank and request that programs be implemented. In any event countries should put adjustment on a continuous basis: countries urgently need to focus on more active exchange-rate policies, on the efficient use of resources, institutional reform, increasing savings, and so on.

Continued World Bank lending is a critical element in the strategy. In the 1970s commercial bank lending to LDCs grew at about 20 percent on a compound basis; now it is growing at a 4 percent rate. New money packages have forced the banks to put up 4 to 7 percent of their existing exposure. By and large banks have been cooperative. They have rolled over $100 billion in the past couple of years. It must be recognized, however, that there is a potentially serious problem of negative net transfers. It is not unlikely that in some cases the banks will increasingly bear part of the adjustment effort.

The final element of the strategy is the provision, on a highly selective basis, of official bridge finance. This finance may be appropriate, in a limited number of cases, for countries which initiate adjustment efforts, to provide time for IMF-sponsored programs to be designed. It can also serve as a catalyst for commercial bank financing.

Policy Implications

What are the policy implications of the strategy just outlined? The first, obviously, is the need to consolidate and maintain the recovery. The second is to promote an open and expanding world trading environment, avoid protectionist pressures, maintain momentum for a new trade round, and integrate the less-developed countries into that round. The third is the need for the U.S. government and governments generally to liberalize market forces and reduce government intervention and government spending. Obviously the international financial institutions should continue to be supported, although it must be borne in mind that resources are limited and the principal role they can play in this situation is essentially qualitative. There is a need also for adequate trade finance to be provided by the OECD governments. Continued close cooperation is essential.

The developing countries themselves must carry through on the adjustment process, institutionalize it, and place it on a continuing basis. Clearly the high-debt countries should pursue more outward-looking policies and should be receptive to direct investment.

No Magic Answer

There is no magic solution—no one solution. The proposals currently on the table touch various pieces of the problem. Essentially we have a medium-term financing problem. We would like to increase the amount of financial flows to developing countries that don't require current debt service. We want equity capital, foreign investment and private sector money and investment going into these countries, but we can identify only selected countries and selected types of financing where we can have leverage. So there is a number of different policies and each has its costs and benefits.

Jimmy Wheeler

Generally speaking there is a clear need to improve the quality of credit in the 1980s. In the 1970s the quality of credit suffered not only among commercial lenders, but also among official lenders.

There is also a need for more equity finance and co-financing, and among the banks particularly, there is a need for more innovative corporate financing techniques. For example, in the United States, there are probably half a dozen ways that an energy project can be structured, but in the international lending business all that is available is term financing. No equity override, no incentive financing, no limited partnerships. There is a paucity of available corporate financing instruments. The commercial banking community and the borrowers are going to have to come up with new instruments for financing projects in LDCs.

Encouraging Private Investment in Developing Countries
—Richard J. Smith

In looking at the U.S. debt strategy, it is important to start with what our objectives were. The first major one was to protect the integrity

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of the international financial system. This involved as a sub-goal avoiding the failure of major U.S. banks. The second major goal was to return to a situation in which developing countries could service their debt and attract new lending on a voluntary and prudent basis and could use that lending to contribute to their development. We have already made progress toward that goal. Indeed, adjustment has occurred to a remarkable degree. In the cases of both Brazil and Mexico, for example, the very tough targets that were set in consultation with the IMF are being met and exceeded.

In the future, bank lending will be at a more modest level than it was in the 1970s, and it will be concentrated in the advanced, newly industrializing countries.

Also, the longer-term adjustment must take place in the context of growth. The growth curve is shaped like a J. That first little downtown has been passed where the countries concerned have been pressing down on demand and on imports and have made some very tough decisions that were necessary in the short run. But in the long run growth is essential.

The case-by-case approach still makes sense. It is the only way to deal with the range of problems we face in different countries. One really does not want to institutionalize this crisis. It is the result of a number of peculiar circumstances coming together in the early 1980s. So far we have had considerable success in putting packages together for particular countries in dealing with the problem. That still should be the basic approach, although it is frustrating and nerve-wracking for everybody involved. In the case-by-case approach, banks and the debtor countries, as well as developing countries that are trying to help in the process, are involved in high-stake negotiations. Usually before a balance is struck all parties have come close to the precipice. In other words, the readjustment packages have not been quite as serious a crisis in each case as they have seemed. As an American humorist said about the music of Wagner: it is better than it sounds.

We must look for ways in which the thrust of adjustment can be maintained over the long term. In that regard, the role of the World Bank should be expanded. For example, structural adjustment lending should be looked into. Also co-financing which brings the project lender into a package with the World Bank has a larger role to play. It is time for the World Bank and its major and minor shareholders to come together on some way of having that institution as well as the regional development banks play a role that picks up from the balance-of-payments-type assistance available from the IMF and provides structural conditionality. That should pay long-range dividends and keep developing countries adjusting in ways that will be helpful to them and to all of us.

One of the key problems we are left with from the late 1970s is a major and undesirable shift in the equity-debt ratio with equity way down. Now we must concentrate on rebuilding that ratio and bringing private investors back into the developing world again. The great advantage of private equity is that if the schemes don't succeed, then there is nothing due. Bankers do not seem to feel that way. If their funds are badly used, they still have to be paid back. Private equity flows also bring with them technology and management involvement on the part of the developing countries that cannot be arranged in any other way. The U.S. government is working quietly but very hard on this.

The Administration has a very active bilateral investment treaty program. About a half-dozen treaties have been negotiated, and many more negotiations are in process. They involve developing countries from all of the major regions.

The Administration is also negotiating a transnational code of conduct in the United Nations. Recently the whole attitude towards multinational and private-equity financing has changed remarkably for the better. Developing countries may be nearing the time when agreements can be formulated with the United States that will play an important role in reattracting, with appropriate assurances, the private investment that has an absolutely essential role to play in their recovery.

Differential Treatment of Debts—*Robert Gemmill*

An assessment of the expected aggregate flows to non-OPEC developing countries shows that international banks as a group are going to have to supply a substantial amount of funds, although the bank flows will probably be only about half the size of the net extensions of bank credits in the period 1979 to 1982. Federal Reserve bank simulations suggest that the current-account deficits of the developing countries for the next few years will be about two-thirds the size of the deficits in the earlier period. With these lower current-account deficits, bank financing is expected to drop more than in proportion from the levels of 1979 to 1982—and to account for about one-half of the projected total flows of funds to the non-OPEC developing countries. A round number for net bank financing that people have used is $20 billion.

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This is somewhat above what seems to have happened in 1983, when the bank credit flows were more like $13 or $14 billion. Probably over the next few years bank credit flows to non-OPEC developing countries are going to have to rise from the very low level of 1983, but they will be substantially below the halcyon days of bank lending. This level is sustainable in principle if capital flight is not being financed.

U.S. banks account for about 40 percent of the total bank credit to developing countries. This means that outstanding claims on these countries by U.S. banks would increase by $7 to $8 billion a year — which is an increase of about 7 to 8 percent annually. Since the capital of U.S. banks has been growing at about 10 percent a year, an increase in absolute exposure to developing countries of 8 percent implies no increase in exposure relative to capital. It probably means a decline for most banks. Thus, on an aggregate basis, the numbers do not make the problem appear unmanageable, provided, of course, that the assumptions underlying this general scenario are met.

There are clearly several areas of doubt. One is that the assumptions may turn out to be over-optimistic. The second is that individual countries face unique problems. It is one thing to say that in aggregate the figures look reasonable, but it is quite another to deal with the particulars of individual countries.

There is increasing recognition that we need to build on the limited successes that have occurred to date. We should think about differentiating debt in ways that would improve the financial prospects of those debtor countries that have achieved effective adjustment or that may improve the external prospects of some countries that still have adjustment ahead of them.

Debt is not a homogeneous mass. There are a number of general problems that need to be recognized in examining the scope for differential treatment of some debts. First and foremost is the danger of a precedent. Any concessional terms provided to one debtor, whether it is a country as a whole or a borrower within a country, could be demanded by another. One way of dealing with this problem is through some sort of certification process: countries would be eligible for concessional terms if they have a stabilization program approved by the IMF.

A second problem is that banks of different nationalities or banks with different types of operations have varying interests because of their tax situations and their customer relationships. Some of them have only a short-term and transitory interest in international business, while others are in for the long term. One way of dealing with this problem may be through loan swaps among banks. In principle there might be some scope for banks to swap domestic credits for international credits, allowing some of the small reluctant banks to get out of certain loan packages in exchange

for assisting the money market banks to rid their portfolios of troublesome domestic credits.

A number of ways of differentiating debt have been put forward, and others will surely appear. Banks have a strong interest in innovating. They know the situations in particular countries; they know where it will be possible to introduce particular variants from what has come to be the standard formula, and they may be able to deal with small but significant pieces of the problem by innovating on particular types of credits.

One innovation that has been mentioned is multi-year rescheduling. This approach has a number of clear advantages. It would reduce the requirement for new money to the extent that new money is called for to meet amortization payments. It would give more scope for economic planning by the debtor country and could be used to reward success where a country has achieved a workable adjustment program. It is quite difficult to imagine how a finance minister can ever put through domestic programs if he must constantly be visiting his creditors.

Some banks have pointed out certain disadvantages of multi-year rescheduling. It could reduce their ability to put the screws on the debtor. They would also have to give up some short-term claims. But although these claims may be short-term in a formal sense, they are long-term in the economic sense.

The second way of differentiating some debts is to take payment in local currency. Where banks have the possibility of making an investment in financial institutions in major debtor countries, and there are a few, it may be possible for the bank to take payment in local currency on the understanding that the debtor will enable the bank to invest in a subsidiary bank. Large amounts of external debt for a large number of countries cannot be taken care of in this way, but in a few countries it may be a way to nibble away at the debt.

Finally, a third way of differentiating some debt would be to develop some innovations to lessen the interest-rate risk which bears on the debtor. Various possibilities have been suggested. One is longer maturities. At the extreme, fixed rate loans might be offered. If a bank cannot go all the way to a fixed-rate loan, perhaps it could consider a longer maturity—twelve months instead of the one-, three-, or six-month pricing options that are typical with syndicated credits. Another possibility would be to average interest rates over a period of time.

In closing, I should emphasize some general propositions to be kept in mind for the long term. Both the banks and the U.S. government have a strong interest in preserving private enterprise in the debtor countries. However, if the banks seek to make the governments of less-developed countries responsible for the debt of private obligors, they run the risk of undercutting the role of free enterprise. That will not be in the

long-run interests of banks that expect to stay in the international lending business.

As we consider the process, we need to recognize that supervisory systems here and abroad have been evolving. In the future, the supervisors will need operational experience under the existing structure and under the structure that has still to be put in place. However, it is unlikely that supervisory regulations would get in the way of any of the kinds of innovations that I have suggested.

While we are all dependent on the IMF to make the process work at the present, we must remember that it could be dangerous to overload the IMF. In particular, it should not become the arbiter of international capital flows—operating an on-off switch. That argues for keeping some flexibility in the process and dealing with the problem on a case-by-case basis rather than trying to come up with a formula which builds the IMF in forever.

Sharing the Risks

Growth in commercial bank lending to developing countries is eventually going to be necessary, but risky. The risks should be shared. Having the U.S. government take 100 percent of the risk in Ex-ImBank loans is not the only alternative.

For example, a variety of risky loans from developing countries could be pooled. Several banks could get together and sell bonds which have a little bit of Mexico debt, a little bit of Brazil debt, a little bit of the Philippines debt in them. The diversification provides a certain amount of stability in that pool.

Jimmy Wheeler

The Role of Lending Limits—*Robert R. Bench*

In considering additional flows of credit to Mexico or to Brazil and possibly to Argentina, depending how those loans are structured, the U.S. banks could run into lending limit problems where they, by statute,

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would be prohibited from lending any additional money to these countries. (U.S. banks are prohibited from lending more than 15 percent of their capital to one person—a country is defined as a person. However, if a government has various state entities that operate on a commercial basis, each one may be permitted its own lending limit.)

Over the last two years that the banking agencies have been involved in the collective assistance for these countries, questions of lending limits have come up because some banks were either at their limit or very close to it with certain countries. However, there are always exceptions. During the last 18 months a number of banks have used the exceptions to the lending limit in a proper way to provide additional financing to these countries. But even those exceptions are being used up.

For instance, there is a separate and distinct limit on financing of acceptance. In the case of Mexico, $4 billion acceptance financing has been completed. The U.S. Congress has reconfirmed this several times and indeed has increased the limits banks can lend under an acceptance facility. But the point is the straight loan could not be made unless acceptance facilities were used. That was a way to accommodate the country within the law and within reasonable credit bounds. That route is now being used up by many banks.

Similarly, many banks have always had the authority to lend through their holding companies. However, when a bank does that, it relies on different sources of funding, primarily commercial paper. If a bank chooses the alternative of lending in a subsidiary that is not financed by deposits, then there is a limit to how long the market will continue to accept putting money into that subsidiary for this purpose.

These real world regulatory restrictions are coming to bear on the continued large participation by U.S. commercial banks in the flow of international credit.

In addition to statutory limits, many U.S. banks—those that were caught in the early 1980s with second-and third-class credits in the energy and real estate area—have been required to enter into an agreement with the Office of the Comptroller of the Treasury that they will not put any more marginal or weak credits on their books. The directors of these banks sign an agreement which becomes, in effect, a civil liability on their behalf if they violate it. Therefore, a large number of primarily regional banks are reluctant to offer any large additional amounts of credit to developing countries because they may have signed one of these agreements.

It is a truism that the ultimate regulator of banks and credit flows is the market. Recently the market has reacted violently to additional participation by U.S. banks in Latin American credit, or that is the perception. It could be that the banks' loans to less-developed countries is

a factor weighing on the marketplace's future to put large certificates of deposit or additional capital into major banks.

All these factors amount to a new reality for banking regulators and for the flow of credit to developing countries. There is an increasingly high politic that comes to play in bank participation in lending overseas. The banking industry and the bank regulators are operating in a large fishbowl under the close scrutiny of the media, the marketplace, and Congress. The borrowing countries themselves also introduce politics into the lending and particularly into the participation of commercial banks in that lending. When various borrowing countries announce that they are going to meet to consider capping interest rates or the appropriateness of interest rates or terms for multi-year rescheduling, that increases the politicization of the whole business.

In the future U.S. banks as a group will lend only modest additional amounts to certain developing countries; however, even to do that, they will have to shore up their balance sheets in the form of capital and reserves. It appears that deposit and equity markets will not invest in a bank unless it shores up its balance sheets with more loan-loss reserves or additional capital.

On the positive side, however, it is possible that over time many banks could return to lending on a more regular basis to developing countries provided that a number of problems in their domestic portfolios turn around through recovery of the economy, thus making them less vulnerable to the international scenario. For instance, not long ago 82 percent of Citibank's earnings came from overseas. Today that number is down to about 52 percent. The Bank of Boston's earnings used to be 40 percent from overseas. Today they are under 30 percent. As U.S. banks are deregulated, they are permitted to have more product power and geographical power within the United States. Consequently, they build up a much broader stream of domestic earnings and a smaller percentage of international earnings. As the international component becomes less, the banks become less and less vulnerable to international problems and can reassess the degree to which they want to increase their international lending.

5.

A Desirable Structure for Official and Commercial Lending to Developing Countries

Paul H. Boeker

The volume of commercial bank lending to developing countries was probably too high in the 1970s, and it is probably too low today, relative to official flows. The optimum level may be somewhere in between those two extremes. But taken alone those levels do not tell us very much. What is important is the soundness of the individual developing country and its economy into which that lending, private and official, is going. If a country is going significantly into debt for balance-of-payments purposes to improve its future growth prospects, it must be able to shift resources into the external sector to improve its ability to service that debt: the adjustment question basically. In addition, its economy should be structured in such a way that it can generate savings and investment, improved efficiency, and higher growth in the future.

Probably the most important thing commercial bankers can do to encourage borrowing countries to put forward effective domestic policies is to discriminate among the countries they lend to. Thus the behavior of the banks sends a message to the borrowers that a large amount of balance-of-payments financing on attractive terms is something that flows from the condition of a country's economy and policies.

If the proper policies are not in place, commercial lenders are not in a position to set conditions, that is a job that can more readily be done by official lenders, typically multilateral ones. The role of private lenders, apart from discriminating among borrowers, is to support the role of the IMF and to some extent the World Bank, where its structural-adjustment lending follows through on some of the longer-term aspects of healthy adjustment.

In the latter part of the 1970s that framework of official and private lending was not working very well. It is working much better now at a point, ironically, when the flows are much lower. But maybe something significant has been accomplished there which will not be lost in the

future when bankers are again tempted to fall back into a position of turning a good thing into a fair thing into a poor thing by lending too much. The risk is in the nature of the banking business because countries that are adopting sound policies to improve their domestic savings and to jack up their growth rate tend to turn into lousy bank customers.

Official lending plays a critical function in the overall framework because of the conditionality attached to it and the strong incentives it provides for adequate adjustment and economic efficiency on the part of the borrowers. That is functioning much better now than it has in the past, particularly as far as short-term adjustment is concerned. However, looking at how much structural reform has taken place in some of the major Latin American economies, one can be slightly less optimistic that it is all still working as well as it might. All of us have drawn very sage conclusions from comparing the economic structure of some Latin American countries and others in East Asia, but I think some of the Latin American governments themselves have done that to a much less limited extent.

One possible exception is the so-called basket cases in which the confluence of circumstances that brought about the recent crisis has clearly knocked them off the path to creditworthiness in terms of the private market. The over-reaction of lenders to the problem of these basket-case countries may well mean that some of them, in spite of their own economic circumstances and policies, may for some period find themselves in a vacuum. It could well be that for a time some of the smaller developing countries may find more need of World Bank intermediation between themselves and capital markets than one would have thought a few years ago.

Part Three

National Industrial Policy and the International Economic System

1.

Introduction

Philip Trezise

National industrial policy is a rather elastic term which has considerable appeal to politicians, since they can give it whatever meaning they think is appropriate. Normally, however, industrial policy means using the power and influence of government to give a specific structure to the economy, or at least to the industrial sector of the economy. Put another way, industrial policy is a way of directing investments to specific industries and sectors in the interest of higher gross national product or less unemployment or some other objective.

According to textbooks in economics, this approach is essentially a wrong-headed one. They say that if market forces are allowed to operate, capital and labor will find their way into those sectors that produce goods and services most efficiently, while interference by government, generally speaking, is likely to hinder the efficient allocation of the nation's resources. Most economists agree with the textbooks and are either skeptical about or out and out hostile to industrial policy.

Nevertheless, advocates for a U.S. industrial policy are numerous and vociferous. They argue that the textbook model does not correspond to reality, and in truth there are many obvious differences between the assumptions underlying the model and the real world. They say that industrial policy corrects or compensates for the failures or imperfections of a free market system—it helps the competitive model work better. For example, some economists believe that market forces consistently lead to under-investment in research in certain sectors. With an industrial policy the government can compensate for the failure of the market by subsidizing research.

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A somewhat less sophisticated argument for an industrial policy is that since the government already interferes through trade and tax policies and subsidies for various sectors, the problem is not government interference, but lack of coherence. An industrial policy would organize the bits and pieces of policy which do in fact affect the way the economy works and put them into more consistent and coordinated patterns.

The third case for an industrial policy is that other countries have industrial policies. In some cases those policies are associated with economic success and have apparently given industries and sectors elsewhere an advantage over the United States. Perhaps if the United States, by emulating industrial policies in other countries, could cure some of its economic ailments.

2.

Japan: Over-Rating the Government's Influence

Edward J. Lincoln

Today few topics are more controversial than Japanese industrial policy. Japan has grown rapidly and has become very successful in certain international markets. People are eager to find an explanation for that success. Some see it in industrial policy; others say that industrial policy had virtually nothing to do with the Japanese success story.

I feel strongly that for Japan industrial policy probably has not been as important as most people think it was. Certain policies of the Japanese government have a contribution to growth and development, but their importance has been exaggerated.

Post-War Government Policies

In the post-war period the Japanese government provided political stability, no mean feat. Other countries in the area have seen their growth interrupted at times of political instability, whereas Japan has had the same political party in power since its formation in 1955. In addition, Japan's political framework is responsive and non-repressive; it is one thing to have stability but quite another to have stability without repression.

Second, Japan provided an educational system that was supportive of economic growth, if not deliberately geared to industrial goals. Japanese children attend school longer hours and more days per year than American kids do, and they tend to score high on international tests for science and math.

The third element is that the government favored spending on

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aspects of infrastructure that were useful to industry rather than on public amenities. For example, it spent very little money on improving sewer systems or sidewalks in the 1950s and 1960s. Instead, it built railroads, highways, and harbor facilities. As late as 1960, very few individuals had telephones in their homes; most of the installations were for businesses. The business demand was met first by the government-owned telephone company.

Finally, the government provided a legal framework for economic activity that was conducive to economic development. The changes made during the occupation were part of this legal framework: establishing an anti-trust framework and breaking-up the zaibatsu helped to create a more competitive environment.

Macro-Economic Policies

During the 1950s and 1960s Japan had an overvalued currency, causing it to face periodic deficits in its balance of payments and the threat of having to devalue. To cope with these problems the government enforced strong capital controls, discouraged Japanese business from borrowing abroad, and itself absorbed a small share of domestic economic resources. This was partly a deliberate choice, I think, not to put pressure on financial resources, not to crowd out private investment. In contrast, the U.S. government currently assumes that it can occupy a big share of the economy and run a large deficit by pulling in resources from the rest of the world.

The Japanese government also firmly supported an interest-rate structure in the domestic economy that was below market-clearing rates. The real interest rates in Japan might not have been particularly low, but they would have been higher had the market been the sole determinant.

The Economic Planning Agency (EPA) engages in macro-economic planning by periodically issuing long-term forecasts of the economy. In the 1950s and 1960s, these forecasts had a psychological value. They began at a time when people did not expect Japan to grow rapidly, and looking back one can see that virtually all of these economic plans underestimated the actual GNP growth-rate of Japan, but when they were issued, people were surprised and felt that the goals were unrealistically high. The plans indicated what the government thought the potential of the economy was and helped to bolster expectations.

Finally, the government skewed the tax structure to promote savings and investment. However, every economist who has studied the

Japanese tax system has concluded that this tax structure had no major impact on the high savings and investment rates in the Japanese economy.

Micro-Economic Policies

On a micro-economic level, there is a distinction between commercial policy or the restriction of imports and other forms of policy. Import policy is an older, more traditional form of support for domestic industry that has been followed by all countries. Import policy was the most important industrial policy element in Japan at the micro-economic level.

In the 1950s and early 1960s, Japan had very high tariffs and very stringent import quotas. These were, by and large, across-the-board restrictions. It would be difficult to pick out one manufacturing industry and say that it received proportionally more protection than another. If there was any targeting on import policy, it was that raw materials and certain kinds of industrial supplies were allowed to enter rather freely, while virtually all manufactured goods were subject to heavy restrictions.

In addition to tariffs and quotas, there were very severe restrictions on foreign direct investment in Japan. No foreign company could have more than a 50 percent interest in any operation in Japan and still be able to repatriate the profits. IBM, the only exception, was granted the exception on the grounds that it promised to license its technology to its Japanese competitors.

These protectionist policies were accepted by industrial nations until the early 1960s when Japan came under pressure within the GATT (General Agreement on Tariffs and Trade) to lower or eliminate these barriers. There were two reasons for this. First, in the 1950s Japan was so unimportant in terms of economic size that other nations did not care what it was doing. Second, the idea of protecting infant industries was accepted as legitimate.

The danger with protectionist policies is that the industries rarely advance to a point where the barriers can be taken away, and even if they do, political forces within the country make it difficult to bring the barriers down. And yet, since 1962, Japan has consistently moved toward greater access to its market. Under pressure from abroad Japan has lowered tariffs and eliminated quotas. Japan now has the lowest average tariffs among industrial countries, and its quotas are more or less in line with the number of items under quota in other countries. Trade barriers are no longer a realistic tool for Japanese industrial policy.

Some casual analyses of industrial policy in Japan say that Japan protects an industry from foreign competition in its early stages and then removes that protection when the industry matures. It is true that Japanese industries were protected when they were small in the 1950s, and the protection was removed in the 1960s and 1970s. But that pattern cannot be repeated today in any consistent way without incurring the wrath of the United States and other countries.

The other kinds of micro-economic aid require a more positive commitment of government fiscal resources to industry than import protection does. There are a number of actions that can be taken; each is mentioned below. Although Japan does something under each of these categories, what it does is in most cases not sufficient to make much difference to what has happened in the marketplace.

The Planning Function

At the micro-economic level the Ministry of International Trade and Industry (MITI) provides its visions of the future which come out every two or three years. This is a ten- to fifteen-year forecast of what the ministry anticipates will happen to the industrial structure. Unlike *The Industrial Outlook* published by the U.S. Commerce Department, this is not just a straight forecast based on the best available assumptions of what will happen. MITI's forecasts indicate as well what the government would like industrial structure to be in the future. (The macro-economic forecast put out by the Economic Planning Agency does the same thing.)

What value do these documents have in determining the course of policy in Japan? One of the problems with them is that they are consensus documents. Each of MITI's bureaus deals with a particular industry, and there is great pressure in each bureau not to say unkind things about one's particular industry. As a result there is a tendency to say that all industries will grow. In addition there are few figures in these documents and no commitment that government resources will be provided to make these "forecasts" come true.

The aircraft industry is a clear example of the gap between vision and reality. In the early 1970s, the MITI forecast spoke rather eloquently of large commercial aircraft as one of the industrial pillars of Japan. That expectation did not materialize. By the late 1970s and early 1980s, the expectations were diminished to calling for Japanese companies to learn something about aircraft by organizing joint ventures to supply parts for large commercial aircraft projects in other countries. That is, in fact, the route that the aircraft industry has taken.

One of the reasons that the grandiose plans for the aircraft industry did not materialize was that the government was unwilling to put

much money into generating that outcome. In 1972, American companies were approached to participate in a plan to design and build a new aircraft in Japan; these companies could see, however, that the Japanese government was not willing to put into the plan the money that would be required for it to be a success.

Access to Capital

In Japan the Fiscal Investment and Loan Program (FILP) provides investment money from the government for the private sector. The money in this program comes from certain financial activities in which the government is engaged, primarily the Postal Savings System. Virtually every post office in Japan is also a savings bank, and the money deposited in Postal System accounts is lent through the FILP. There are some other monies which go into it as well—such as government pension funds.

This money finances such things as harbors, airports, mass transit systems, schools, and hospitals. In the private sector, the bulk of it goes to agriculture and small business, a pattern that looks remarkably like the United States. The major difference is simply that most of the organizations which borrow money from the FILP do not issue bonds. In the United States, highway authorities issue bonds if they want to build a new turnpike. In Japan, the highway authority borrows money from the FILP or from one of the financial lending organizations that receives its money from the FILP.

Therefore, the bulk of FILP money goes to the same kinds of activities or industries which borrow money in the United States through a different means. However, there is one organization in Japan that provides capital for the private sector which has no parallel in the United States—the Japan Development Bank. This bank receives money through the FILP (and also raises money through bond issues) and then lends to the private sector for the purposes of economic and social development of the country.

Some observers say that the Japan Development Bank is the linchpin of Japanese industrial policy because it provides loans based on the government's plans for industry. They maintain that a corporation which receives a loan from the Japan Development Bank then finds it much easier to borrow from other commercial banks. Perhaps this contention is true, and yet in all the reading that I have done on Japan, I have never seen a single example of a corporation which had an easier time raising money from the commercial banks after having received a Japan Development Bank loan.

When one looks at who gets money from the Japan Development Bank, a different picture emerges. The Japan Development Bank has

provided capital for the steel industry, the ocean shipping industry, land transportation (including the private railways), and electric and gas utilities. These are the industries that have lower-than-average profit rates. What the Japan Development Bank is doing is providing heavy support for some basic industries and utilities. Every single electric power company in Japan has approximately 25 to 40 percent of its total outstanding loans from the Japan Development Bank. However, for the machine tool, automobile, or pharmaceutical industries, the proportion is under one percent. In fact, most companies in industries like machine tools or robotics have no loans whatsoever from the Japan Development Bank. In other words, the data show that the Japanese Development Bank is not biasing its loan portfolio in the direction of new and growing industries.

In the 1950s, the picture was quite different. In that era the Japan Development Bank was an important lender to industry because the rest of the private financial sector was in disarray. At the beginning of the 1950s, the government provided about 50 percent of total bank loans to the private sector. There was an important role for government financing at that time because of conditions which no one would think applied to either Japan or the United States today.

Today the U.S. government lends twice as much to the private sector as Japan does. And since the U.S. economy is twice as large as Japan's economy, government lending is about the same in both countries. The Japanese are perhaps a bit more aware of what they are doing than we are in the United States, and the FILP program is more highly structured than equivalent mechanisms in the United States, but that is about the most that can be said.

Direct Subsidy

Here there is very little difference between Japan and the United States; direct operating subsidy is not a preferred route in either country. However, some industries have received direct subsidies, such as urban mass transit. Mass transit systems do not show a profit, but the Japanese have accepted the necessity and the social benefit of providing transit services in densely populated urban and suburban areas by giving the government-owned Japanese National Railways a subsidy. However there are endless disputes in Japan about how large those subsidies should be, just as there are in the United States.

Agriculture is another industry that receives direct subsidies by paying farmers a price for rice that is higher than the consumer price. Ocean shipping is also subsidized to some extent in Japan, but the subsidies there are much smaller than they are in the United States. There are a few other direct subsidies being paid in Japan, but they are very small.

Support of Research and Development

The raw data shows that the level of support for R&D in Japan is much lower than in the United States. In the early 1980s, the Japanese government funded 26 percent of the total spending on R&D, whereas the United States supplied close to half. However, there are certain differences in calculation. In Japan, R&D spending by organizations like the Nippon Telegraph and Telephone Company or the Japanese National Railways, which are both government-owned organizations, is not included as government R&D spending. If those organizations were included, the figure for Japan would be somewhat higher.

The main difference, though, is that Japan has virtually no military R&D. If military R&D is subtracted from the total R&D spending in the United States, the government share comes down to around 32 or 33 percent—much closer to the figure for Japan. Perhaps not all military R&D should be subtracted. While there are arguments on both sides about the spillover effects of military R&D, some spillover does take place, and there is no doubt that the United States dominates international trade in military hardware, an industry in which Japan has no presence whatsoever.

Not only does the Japanese government actually provide less support for R&D than the United States, but total R&D spending as a percentage of GNP is also lower in Japan. The Japanese government wants to increase that percentage but has been relatively unsuccessful in finding ways to do so. The government provided a tax break for R&D spending quite similar to the one provided in the United States, but the U.S. tax break is larger.

Until very recently, a lower level of R&D spending in Japan was acceptable because Japan was involved primarily in the importation and adaptation of foreign technology. It will be interesting to see whether the Japanese corporate sector and Japanese government policy to support R&D will be able to generate larger sums of money for R&D as Japan continues to move toward the international technology frontier.

Anti-Trust Policy

Unlike many nations, Japan has an anti-trust policy. However, its provisions and their enforcement are weaker than in United States. Whether that is an advantage to Japanese industry depends entirely on one's view of industrial competition and how it is affected by anti-trust policies—a question that can be argued either way. If one believes that collusion hinders the development of markets, then perhaps the Japanese have not benefited. On the other hand, one can argue that under Japanese anti-trust policies there has been greater freedom for Japanese government and industry to discuss the future of an industry with leaders of different

companies all sitting in the same room without their lawyers sitting next to them. That may provide some minor advantage to Japan.

Favorable Tax Treatment

In the Japanese tax system, particular kinds of activities or industries are favored. One of the principal methods is by making particular kinds of products or capital goods eligible for extra fast depreciation write-offs. However, as I stated earlier, economists who have studied the Japanese tax system have not been able to show that tax-breaks have affected the direction or the speed of industrial development.

Whatever their impact, the scope of these tax policies today is much smaller than it was previously. Each year the Ministry of Finance estimates the revenue lost due to tax policies favoring certain industries. Throughout the 1970s, the amount of lost revenue as a percentage of total corporate tax revenue declined. In Japan the overriding concern of the Ministry of Finance is how to reduce the government deficit, but it is facing tremendous opposition from individuals over raising income taxes. Given this political climate, the Ministry of Finance is reluctant to grant any special corporate tax breaks. At the same time, MITI is pressing for new tax breaks for industry, but it has been unsuccessful in arguing its case with the Ministry of Finance over the last decade. Studies show that as a result of these changes, average corporate taxes in Japan are now higher than they are in the United States.

Aid for Export Development

In the 1950s and 1960s Japan followed a policy of trying to promote exports. That was a time when Japan had an overvalued currency and went through various balance of payments crises. Not wanting to devalue its currency, it was looking for other methods to escape from these periodic problems, including the promotion of exports. The government followed a number of export-promoting policies, including, for example, a tax-free reserve to corporations for overseas market development. It also set up a special government-owned organization called the Japan External Trade Organization (JETRO) to provide market research for smaller corporations that might have trouble getting information on foreign markets. Japan also established an Export-Import Bank.

Those policies, however, were largely dismantled in the 1970s as Japan no longer faced its former balance-of-payments constraints. The tax-free reserve has been eliminated except for medium and small companies, and in Japan, as in the United States, medium and small-sized companies provide a rather small share of total exports. JETRO has seen

its functions change. At first it focused almost exclusively on export promotion, but now it is both export- and import-oriented. JETRO's budget shows a very rapid rise in the share of its budget allocated to import promotion over the last decade, where the same shift has taken place in the Export-Import Bank. The percentage of loans it has granted for imports has risen over time.

At the present time, the Japanese probably cannot create new programs to increase exports. They already face heavy foreign criticism for running trade surpluses, and they are scurrying around to find ways—at least officially—to encourage imports.

Industrial Policies and the Japanese Economic Miracle

These areas in which the government has had economic policies do not add up to a great deal, even though particular industries in Japan clearly owe at least part of their success to government policy. Computers might fall into that category, but even there, one wonders if government policies have had that much of an influence. The amount of government money lent to the computer industry was relatively small. What really happened was that the home market was protected, through high tariffs and quotas and through restricting investment in Japan by foreign companies.

When economists look at Japan, they see that industrial policy was only one factor of the Japanese "economic miracle." The other economic factors were much more important than industrial policy in the overall growth of the Japanese economy in the 1950s and 1960s.

3.

France: A State-Managed Industrial Power

Michael Harrison

Since May of 1981 and the victory of the Socialists in France, the role of the state as a manager of industrial transformation has expanded. France represents perhaps the most clear-cut attempt at state-managed industrial adjustment to the crisis of growth, productivity, and international competitiveness that Western economies are facing.

Why such a major economic role for the state in France? Capitalism developed rather late in France, and since the middle of the 19th century, the state has protected incipient domestic capitalism as well as agriculture from foreign competitors. Up to World War II, this government policy retarded industrial development in France and was one cause of French weakness and decline by the inter-war period.

Slow growth and problems in the French industrial economy led during the war to a major reconsideration of the possible role of the state, and to a consensus on the part of both left and right that the state had to take an active, positive role in restructuring the industrial economy and advancing economic growth. Policymakers decided that firms, entrepreneurs, and capitalists had failed to enhance the country's economic strength. Without state assistance and direction, these private forces were felt to be essentially incapable of insuring that France would somehow become a major industrial economy and recover its lost status in the world.

The state role, a reaction to the problems that France had in the inter-war period and during the war itself, has until recently been accepted as essential by the public, by bureaucrats, and even by business, which once depended on the state to protect it from foreign as well as domestic competition and now expects government's help to make it competitive in the international economy. These and other new attitudes amount to a new

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post-war approach to industrial policy which has experienced four stages of development.

Stages in Post-War Industrial Policy

The first stage was the period of reconstruction from 1946 to 1958 when the state first took on a positive role in industrial development. Industrial policy focused on developing a basic industrial infrastructure to foster industrial development: steel, railways, coal, and basic energy. The essential mechanism for this industrial policy was the indicative planning process developed by industrialist Jean Monnet. From 1948 to at least the mid-1950s the small group of planners—most of them in the Treasury—were able, through a long process of consultation, to get agreement between business and the bureaucracy. Labor was excluded from the industrial planning process. If labor had been involved, especially in a country where it often is attached to the Communist Party, there would have been no consensus on national goals. The planning process functioned by setting basic targets. The Treasury allocated funds according to these development targets in the basic sectors. All targets were met or surpassed during the period of the Fourth Republic, a very successful period in planning. During this early period the use of credit instruments was developed. It subsequently became a persistently strong feature of French industrial policy.

The second stage, starting in 1958 and running until around 1974, was characterized by economic expansion. The French economy opened up to international market competition. Probably the most important development during this period was the creation of a stable political system and constitutional order. A strong executive and a highly-motivated, technocratically-oriented elite mobilized national power and increased France's international economic and military prestige.

However, as France entered the European Economic Community, general state controls over the development of the economy were weakened, prices ceased to be controlled, the economy was opened to more and more competition, and the general flows of credit and investment throughout the industrial economy were less and less channeled by the state and more and more given over to market forces. The state focused on specific economic development projects, labeled a national champions policy, which supported major efforts such as the development of the French aerospace industry. It worked very well in terms of arms development, but not very well in the case of the infamous Concorde. It focused government investment on nuclear energy industry and the modernization and expan-

sion of steel production. Particular sectors and firms were targeted by industrial policy to enhance national independence, prestige, and the export viability of these industries, since President Charles De Gaulle and the bureaucracy wanted France to be a major economic as well as military actor in the world.

The government specifically encouraged the development of giant firms and the concentration of industry during this period, and it has continued to do so until very recently. The French simply have not believed in much domestic competition. There is no legitimacy to it, they feel. Anti-trust is a concept that does not exist in France. The French do not have much fear of virtual monopolies in various industrial sectors.

The third stage in industrial policy, from 1974 to 1981, was a time of general international crisis and uncertainty about how to meet the oil crisis shock. New competition, especially from newly industrialized countries, presented France with a number of problems. National industrial policies had to be adjusted to the international economy.

During this period a major debate began in France about what the desirable balance of state and market forces should be regarding industrial adjustment to the new international economic order. (The debate is still going on and has been intensified since the Socialists took power.) This debate polarized after 1974, and particularly after 1976, when the left attacked the market liberalism approach of Valery Giscard d'Estaing and Raymond Barre and instead developed an enhanced interventionist perspective to recover what they saw as a loss of state control over the national economy. The whole economic debate in France in the 1970s was highly politicized, and since most economists in France are politically committed to one side or the other, it is almost impossible to find an independent assessment of what goes on there.

From an external perspective, however, both sides accepted high levels of state intervention and debated about partial state withdrawal, not full withdrawal. Looking at the figures for government subsidies, government spending, and intervention in the economy from 1976 to 1981, one is struck by how little the real role of the state actually changed under the liberal policies of President Giscard d'Estaing.

These policies brought about the decline and actual demise of economic planning as a mechanism to direct the French economy. This was an inevitable development. The seeds of it were laid in the 1960s as the French economy opened more and more. By the 1970s it was totally open and had to react to more external, uncontrolled economic stimuli. Up to 40 percent of France's GNP was involved in import-export activities and was directly or indirectly shaped by the international market. All that meant that France simply could not plan as it had before.

Consequently, there was a switch from general planning of industrial development by sector to a rather narrow focus on particular firms and industries. The guidelines used by Prime Minister Barre for deciding which firms would receive government assistance was determined not by government political priorities of employment or national balance of the economy but by international competitiveness. The government tried to determine in which areas France might be competitive internationally in the future and supported firms which would perform best in those areas. The most efficient of those firms continue to be helped by the government; the failing or lagging ones, in theory, were to be allowed to collapse.

This meant that in general there was a loosening of state control over firms. Government controls over prices were relaxed. Government charges on firms were reduced (but only marginally) so that firm profitability increased. Rather than going to the government, more earnings were channeled through the government for its investment purposes. The most profitable firms were allowed to increase their profits on the expectation that they would invest in the country's industrial future.

Barre's industrial policy has a mixed record. The policy had improved export performance by the time the Socialists took over in 1981. Just the same, the policy has to be judged a political as well as an economic failure. The state found that it could not withdraw from failing sectors in any serious way. Particularly in steel, it was forced to keep intervening. If industrial strategy means identifying the winners and letting the losers go, that has never been the case in France where the government has tried to identify the winners but for political reasons really could not let the losers sink. This means that investment funds are constantly distributed among sectors where profitability and market competitiveness is very low.

Reducing the role of state-directed investment policy failed to produce clear results in the industrial sector. French entrepreneurs confirmed their historic failure to modernize and invest in France, which had always been a problem. They took their new profits and invested them in land development projects in the south of France, or they went off to Switzerland or otherwise invested in international capital. In fact, private market capitalism failed more than any other factor during this period.

The Barre policy also resulted in higher unemployment and a decline in real income for important social groups. As more money was put into the hands of firms, less money was available for consumers and private income. The French resented this—and especially resented the growth in unemployment. The results of the elections in the spring of 1981 certainly confirmed that a market-oriented, firm-oriented strategy in France had a mixed economic record, at best, but was a political failure.

Thus, the fourth stage in French industrial policy began in May

1981 with the re-emergence of state intervention in the economy as a whole, and especially in terms of industrial development and modernization. The period has been characterized by over-ambitious, multiple and frequently contradictory goals. An expansionary wage and social policy competed with an industrial strategy in which money and investment funds were to flow into long-range modernization projects and the development of high technology. Both cannot be done in an economic climate characterized by stagnant growth. The story and the lesson of the first two years of French Socialism is that the Socialists tried to do everything and they ended up doing nothing particularly well.

Those first two years were also characterized by intensified bureaucratic infighting, a breakdown of the consensus of the technocrats on economic management, and escalating conflicts between the Ministry of the Treasury and the spending ministries. This political infighting debilitated the government's ability to lay out and pursue a clear strategy for industrial development.

The conflict between the private sector and the government also intensified. Since the nationalizations were completed in early 1982, government and the private firms have been unable to collaborate and agree on where the national industrial economy should go,. Although there were signs of reconciliation starting in late 1983, it is unlikely that that bitterness is going to be resolved during the period of Socialist management in France.

Finally, the poor international economic climate undermined any attempt to have an export-based national economic recovery, whether it is managed by the state or anyone else. In other words, the overall economic role of the French Socialists has been undermined for reasons quite beyond their control as well as by their own mistakes.

Goals of French Industrial Policy Under the Socialists

Probably the most significant overall goal was what has been called (in rather grandiose terms) the "reconquest of the domestic market." It sounds like a war-fighting strategy, and it was conceived as such by the Socialists. The reconquest of the domestic market meant import substitution and the use of the state to develop particular industrial sectors which France either never had or lost in the 1970s.

Specifically the goal was to reduce the external dependence on imports in the industrial sector from 30 to 23 percent of GNP. The main debate was over whether this should take place with or without a major dose of protectionism. In general, the neo-liberals within the Socialist

France and Japan—Surprising Similarities in their Industrial Policies

There are a surprising number of similarities in Japan's and France's approach to industrial policy. Both countries have a bureaucratic elite that is well respected, that has a legitimate role in managing the economy, and that is well informed about what's going on in industry. In the United States, there is much less of that kind of regulation and coordination.

The educational systems in France and Japan are very similar. Educational standards are very stringent; students spend more time in the classroom and come out of primary school with a much higher level of education than is evident in the United States today.

In France and Japan, the role of the state as a planner in the economy is also accepted. The state is expected to coordinate and mediate negotiations between various economic players. Business, labor, and financiers will listen to the government.

Both countries have set targets for overall industrial growth and growth in particular sectors, and they have actively used the tools that are available to them to achieve those goals. In particular, both countries rely heavily on concessionary credit to achieve industrial goals. Even though loans by the Japan Development Bank may not be particularly important to high technology industries today, in the past it has been important for some other industries, such as shipbuilding and steel. There are other financial institutions in Japan, such as the Small Business Finance Corporation, that provide quite a sizeable amount of investment capital to selected industries.

Both countries have had relatively stable political systems, although the 1970s brought about dramatic changes as the two moved rapidly into international markets and were forced to change in response to external shocks like the oil crisis and the collapse of the Bretton Woods system.

Both of them have, until recently, been moving more generally towards a greater role for market forces in determining the allocation of resources. Their views of competition are similar. They view it somewhat less strictly and in a more global sense than we do in the United States.

However, since the mid-1970s France and Japan have gone divergent ways. The French government has decided that market forces have failed to meet expectations and it is taking charge once again. In Japan, the opposite seems to be happening. There has been continual movement towards freer markets in sectors such as finance and telecommunications and a diminishing role of the state in regulating entry and competition.

Even so, Japan still maintains an active industrial policy—initiating cooperative R&D projects, opening the market selectively to high technology imports, and employing other non-tariff barriers to trade. These barriers to trade are not necessarily inconsistent with Japan's international obligations under the GATT. Japan still uses powerful tools to shape its economy, but they have been changed to meet new circumstances and fresh challenges.

Kim Skidmore

regime won out over the protectionists in almost every case where some device, direct or indirect, for protectionism could have been invoked by the French government.

Secondly, unlike the Giscard period where some sectors were allowed to thrive and where "failing" sectors were to be allowed to collapse, the guideline of the Socialist government was that there are no "condemned sectors" at all, but only "condemned technologies." Failing or lagging sectors could be saved through the right amount of entrepreneurship, packaging, marketing, or technological developments. France had only to apply a particular package of approaches to recapture everything it had lost—at least this was the theory.

Finally, there was an overall goal of developing comprehensive chains of production capabilities over the entire stage of development of a particular product, not only the core area of production, but also the subsidiary industries that feed into a production process. For example, the French are strong in automobiles, but they also want to develop a large robotics industry and all the components that go into that so that they can have technological capabilities in all the sectors that support the production of automobiles.

Instruments of French Industrial Policy

The instruments used by the Socialists are not really very new. It is simply that the use of well-known instruments has expanded.

Nationalizations are probably the most notorious new lever that the government has used for industrial policy. The French rationalized these nationalizations first of all by maintaining that they wanted control over monopolies. Nationalization is a somewhat perverse French version of an anti-trust policy and is an alternative to competition within France. The government controls monopolies rather than encouraging competition internally. Second, they wanted to work for more democracy within firms. However, it was safe to assume that even French Socialists were not going to go so far as to give workers control over plants and firms. The Socialists know precisely how much trouble workers can be and had no intention of doing that, especially since worker control might be manipulated by the communist-dominated Confédération Générale du Travail (CGT). Third, and most important, the Socialists wanted to use public firms to restructure French industry for government-determined national and interna-

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tional purposes. These firms were to enhance investment, productivity, and competition along lines of a general strategy laid down by the government, particularly by the minister of industry. These basic guidelines were to ensure that France would develop modern technological capabilities in key sectors of electronics and chemicals.

What actually happened, however, was something of a surprise for the Socialists. They thought they were taking over efficient, capable firms that would give them a useful tool of economic management. But the government found instead that over half the firms were in desperate financial straits. Rather than using the nationalized firms as tools of modernization, the government has been subsidizing them and bailing them out and restructuring them in order to save money. Most of the firms only returned to solvency in 1985.

There has also been a major problem in government-firm management relationships. The flagship French nationalized firm, Renault, always behaved more as a private company than as a competitive firm, with very loose government control. Under President Francois Mitterrand, especially from 1981 to 1983 while Jean-Pierre Chevenement was minister of research, technology, and industry, there was an attempt to apply a more heavy government hand to all the firms in terms of the contracts and investment plans that had to be developed so they would fit more closely with what the Ministry of Industry wanted to do. That led to complaints by the heads of the nationalized firms that the Ministry of Industry was interfering too much. The minister of industry lost and the firm managers won. Chevenement left in the spring, and now Ministry of Industry control is much looser to the point where it played a relatively minor role by 1985.

Probably the most important development has been a major extension of state control over credit allocation via the nationalization of the banks. This development confirms what has always been the main feature of French industrial policy—control over the allocation of credit. This has been true since the late 1940s. France has a credit-based finance system which the government, through the Ministry of the Treasury and the Bank of France, can and often does use as a device for intervening in industrial affairs. Since firms depend on bank financing for investment, the government directly or indirectly has a very flexible and comprehensive mechanism for shaping the industrial development of the economy. It can step back and use that very loosely as it did during the Giscard-Barre period, or it can use it in a much more purposeful interventionist way.

For both nationalized and private firms in France virtually all credit is now available only from government-controlled banks. There has been a major expansion in funds allocated to industry, and the overall

spread of direct and indirect use of investment funds, subsidies, export aids, and the whole range of financial instruments available to the state have expanded since May 1981. Aid in research and development has also been increased significantly.

Conclusions about France's Industrial Policy

France is the most comprehensive state-managed industrial power in the industrial West. There are so many policy instruments and aims linked to industrial policy that it is difficult to isolate industrial policy per se from broader economic policies and goals. Most experts agree that the use of the state as an industrial policymaker and manager in France has been beneficial in the past, so that industrial growth, the technological capability of the economy, and France's international position are stronger than they would have been without state intervention.

As a political scientist, I would argue that this is also due to the nature of a political system in which particular private economic and other interests within the country have a low level of legitimacy.

By 1985, however, the issue became whether the role of the state had not become too strong and even counter-productive after 1981. Indeed, the debate in France leading up to the 1986 elections has been about how to reduce the levels of public intervention in the economy and, instead, encourage the activities of private market forces in the country. There has been a revival of liberal economic thinking and policies that has affected both the left and right, so that some readjustment in favor of market mechanisms and away from *dirigisme* has already taken place and doubtless will be reinforced starting in 1986. One doubts, however, that France will experience more than a rationalization of the state's economic role and some reasonable adjustment in the balance of public and private forces.

4.

Korea: Maintaining Steady Growth

John Bennett

Macro-Economic Policies

The set of macroeconomic policies adopted by Korea is determined by its desire to get a certain growth rate. Korea is now in its fifth five-year plan. On average, its goal is to get 7.5 percent real growth in its GNP. That growth rate is set because it is the minimum required to employ the additional people coming into the labor force. Actually, the country has done rather better than its goal in most years. It has averaged almost 10 percent growth, if one excludes the last couple of years in which the world recession has had a marked effect.

The composition of the set of macroeconomic policies has varied over time. The initial mix included a lot of foreign borrowing, not much foreign investment, a strong push to get the investment rate up, and an emphasis on exports. This involved some adjustments in exchange rates, low interest rates, and a very permissive monetary policy—but no particular concern about inflation. Off and on the Koreans have been concerned when inflation rose to around 15 percent, but 8 percent inflation has been the average, and this has been quite acceptable up to the last few years.

The second mix of policies added industrial targeting to the first list. This involved identifying particular industries, creating incentives for their growth, and protecting them.

The third policy set moved toward more indicative planning and opening companies and industries up to more competition from abroad. But these policies have been constrained by past promises and past commitments.

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The Korean Context

In 1960, the GNP per capita in Korea was about $82. Koreans had come through a war and a reconstruction period with very heavy foreign assistance. The foreign assisters, mainly the U.S. government, concluded that Korea was never going to go any place and wanted to start disengaging. Although the United States had made a commitment to help the South economically after the war, by 1960 this commitment was weakening. Koreans feared that the U.S. military commitment might also be weakening. Because of this the Korean government developed a profound sense of danger. That sense of danger drives Korean policy even today.

Korea is a small country, very densely populated with little arable land and almost no natural resources. It had no alternative but to industrialize and to export. Those two precepts were key to its whole policy.

Another important part of the context in Korea is the relationship between the private sector and the government. This relationship is not seen as competitive. Society as a whole expects individuals, families, and businesses to recognize the national interest and to conform their behavior to it. This means that in a dialogue between government and business, the expectation is that business will ultimately do what the government suggests is in the national interest.

Another part of the context is the government planning system. Since 1962 one five-year plan has followed the other. Those plans are a set of mutually consistent and feasible targets and sub-targets. By and large, the country has exceeded the targets.

In addition there is an annual economic management plan which tries to project what the world economy is going to look like and to modify the current year goals of the five-year plan accordingly. There are sub-plans for foreign borrowing and for particular industries. Companies themselves readjust their own plans, attempting to stay in line generally with the industry plans.

The trade plan considers total exports as well as what products will be produced for export and what the market countries will be. Abroad Korean ambassadors are expected to take an interest in promoting trade are held responsible for reaching the export target in their market country. Imports also are a concern for the Korean government, for, without raw materials and energy, industry in Korea would falter. Since the first oil crisis, energy has received the most attention in Korea's import planning to diversify the mix of fuels and the country of origin.

The overall planning process is augmented by a monitoring system, which becomes, in effect, management by objective on a national

scale. The president meets every month with his economic ministers to carry out a complete review of the progress to date. He also meets monthly with his ministers and the heads of the large companies and representatives from the industry associations who in turn communicate with their member companies. Problems are identified early, solutions proposed, and actions taken quickly.

Change Over Time

In the 1960s, unskilled laborers were leaving the farms and going to work in traditional manufacturing—textiles, plywood, rubber tires—and in the newly established mini-steel mills which produced simple shapes.

In the 1970s, because of the rise of protectionism, the Korean government recognized that Korea would have to diversify its exports and its industrial mix in order to continue to grow at its target rate. Heavy industries were introduced, and an attempt was made to move up the technology scale so that the value added in Korea would be larger. Ultimately that would enable producers to pay higher wages, and the standard of living would rise. Thus, automobile manufacturing, integrated steel production, and shipbuilding were introduced. The shipyards were set up in part to provide enough domestic demand to warrant an integrated steel mill. Chemical industries were also established.

In both chemicals and the steel business, the Koreans had had severe problems. For example, when the market was tight, the Japanese charged the Koreans much more for steel or chemicals than they charged their own manufacturers. Koreans were forced, therefore, to get into some of these raw material industries to protect themselves from price gouging from a competitor.

There was also a military aspect to the move to heavy industry. The Koreans wanted to produce weapons for their own defense.

By the late 1970s the whole thing had gotten out of hand, and in 1979 the Korean government had to adopt a much more restrictive monetary and fiscal policy in order to halt spiralling inflation. Labor was in short supply, and wages were going up very rapidly, much faster than productivity. The government decided that some decisions on investment had been incorrect. The chemical industry, for example, was dealt a severe blow by the energy crisis, and Korea was stuck with some white elephants. The automobile industry was also viewed as an error for a time in Korea. The hope had been that it would become world competitive by following the Japanese model and exporting. It has not yet become world competi-

tive, however, and in the meantime is a very expensive way to satisfy the domestic demand for vehicles. Success in the U.S. market in the next few years, however, would vindicate the decision to invest in cars.

Inflation also created an atmosphere in which misleading signals for investment were communicated. For example, a lot of investment went into real estate, rather than into financing productive assets. In addition, to finance capital-intensive investments, Korea had to borrow abroad at rates which were clearly not sustainable.

The belief now is that these industrial policies tended to concentrate investment in the big companies in the capital city, Seoul, one of the four largest cities in the world and still growing like topsy. And finally there is a feeling that the policies followed in the 1970s contributed to the growth of income inequality—an anathema in Korean society and something for which the government is continually criticized.

Proposed Reforms

One proposal for reform is to privatize the financial system. In Korea there are some specialized government-owned banks like the Korea Development Bank the Korean Exchange Bank. The key commercial banks have also been an arm of the government because it owned enough of their stock to control them. These are the five nationwide commercial banks which have several hundred branches all over the country. They operate to provide funds at low controlled interest rates to private sector companies. Now the government wants to privatize these banks and move to market-determined interest rates. The government has sold off the shares but it has not yet given up control. It is waiting for free market interest rates to drop below the current bank rate so that decontrol will not cause any obvious jump in interest costs.

Another reform is to balance the budget in order to allow the central bank to control the money supply. In wage policy the objective is to reach a state in which nominal wages will go up a small amount, say, 2 percent. Then the bulk of productivity increases, which have averaged about 6 percent a year, will feed back into the economy in the form of lower prices and real income increases not only to workers but also to the public as a whole.

The government is now talking about doing something extraordinary: repaying Korea's foreign debt while continuing to grow. Import liberalization is already going on. By 1986, the Koreans want 90 percent of imported items to be freely licensed for import. They are about to pass a law which will create uniform tariffs for three categories—raw materials,

intermediate goods, and consumer goods. Those tariffs will drop over a period of time. They have begun to promote foreign investment much more slowly, both to obtain newer technology and to reduce the need to borrow abroad.

Finally, the Korean government will try, I think, to emphasize more help to small and medium-sized companies. Although there are tax incentives in the law, these are not particularly important for business because its growth is not based on retained earnings so much as elsewhere. Indeed, business has grown in Korea primarily because it can borrow money. The key avenue to expansion has been credit, mostly from the banks.

To assist small companies, the government encourages credit for exporting industries. With an export letter of credit a business can get an advance of 80 to 85 percent of its value. Thus, working capital requirements for exports in Korea are covered by the banking system. The banks have no limit on how much such business they can finance because they can rediscount the loans with the central bank.

Other means to extend credit to industry have existed over time, but they have not been particularly successful. The Korea Development Bank, for example, has ended up holding bad debts or equity in a number of failed companies. In other words, it is the residual holder of the failures, and that is hardly an object lesson in successful industrial policy.

In summary, Korea has followed an unchanging set of policies designed to achieve rapid growth, full employment, and rising living standards. For a time, it also used a varying set of policies to benefit particular target industries. This, however, resulted in some singularly bad investments, while leaving several industries in which the country was world competitive starved for capital. In recognition of these errors, the government has adopted a market-oriented policy, although it is encountering some transitional implementation problems.

Korea's adoption of market-oriented policies has received the support of the U.S. government and has helped in some measure to mute criticism and reduce restrictions on its exports to the United States. Korea's planners have insisted, however, that the major reason for adopting such policies has been to raise the welfare of their people.

5.

Brazil: Diversifying Exports

Werner Baer

Brazil went through various stages in its industrialization. Prior to the Second World War, Brazil had no industrialization policy. Some industrial growth had taken place in Brazil in the late 19th or early 20th century—mainly in textiles and other light manufacturing industries, which were the by-products of the export boom in primary products, especially coffee and sugar. The depression of the 1930s increased the industrialization process by substantially depriving Brazil of foreign exchange for which to pay for its imports. The shortages that were created automatically gave protection to the country and provided an economic incentive to the industrial sector.

A Multi-Faceted Program of Industrialization

Industrialization as a development policy was adopted only after the Second World War, in the 1950s and 1960s. Brazil adopted an import substitution industrialization policy. The policymakers of Brazil believed that the only way to substantially increase the process of development and economic growth was through industrialization. In the policies they followed, Brazil and most other Latin American countries were influenced by the doctrines of the Economic Commission for Latin America, the famous Prebisch doctrine, named for Dr. Raul Prebisch, an Argentine economist and advisor to the United Nations. This doctrine rejected the 19th century theory of division of labor between the Third World and the industrial world, in which the Third World was the provider of raw materials and food products in exchange for manufactured products from the industrialized countries. Brazilian policymakers felt that such a division of labor would be prejudicial to the well-being of the peoples of the Third World.

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Brazil erected a protective wall around itself, which consisted of tariffs and exchange controls. If they wanted to participate and have a share in the Brazilian market, foreign producers had to establish their industries in Brazil; otherwise, they would be left out. Special tax or tariff breaks were offered. For example, machinery could be brought into Brazil without foreign exchange cover. This was a great incentive, for a multinational corporation could bring in equipment which had been depreciated in the United States or Western Europe and use it once again within the Brazilian market. These were very important incentives for multinational corporations, most of which established production facilities within Brazil in the 1950s and 1960s.

Special Incentives

A number of other special incentives were set up. The Brazilian government established a development bank. This was an important move because there were no capital markets in Brazil. In the early stages of industrialization small, family-owned firms had to finance their expansion through retained earnings. There was no possibility of obtaining outside funds by selling stocks or bonds. Brazilian policymakers knew that domestic firms would have to expand if they were to become supplying firms for the multinationals. And to expand they needed long-term capital; the Brazilian Development Bank was set up to provide it.

In addition, Brazil was very flexible in its attitude toward the role of the state. In the early part of the decade, Brazilian policymakers had had no compunction about setting up state-owned commercial banks, or about gradually buying out the railroads that were owned at first by British companies, or setting up a state steel company in the 1930s when U.S. Steel refused to come to Brazil and when there was no possibility for the Brazilian private sector to go into this sector which was considered to be strategic. To encourage import substitution, the state expanded its activities substantially in commercial and development banking and in the development and expansion of public utilities. Most public utilities operated under price controls and thus were not attractive investment propositions for international corporations. The only way to provide infrastructure that could supply a large manufacturing sector adequately was for the state to step in and found its own corporations and build its own hydroelectric works and distribution facilities.

At first import substitution was encouraged across the board. Brazilian policymakers, like most policymakers in Latin America, felt that

if a country could lower the import coefficient, it could isolate itself from the rest of the world and become self-sufficient. By the 1960s, many policymakers began to change their minds, having become increasingly aware of some of the imbalances import substitution had brought about. For instance, in the early 1960s over 90 percent of exports consisted of cocoa, coffee, and traditional products, even though the industrial sector had surpassed the primary sector in the gross national product. This scared policymakers, because they saw that their efforts had not made Brazil independent of the world economy. Instead of importing manufactured consumer goods, Brazilians were importing raw materials and capital goods which were important inputs for the industrial sector. Policymakers saw that there was always the danger that the price of those primary products that Brazil exported might fall substantially in the international market. If that were to happen foreign exchange earnings would fall and Brazil would have to decrease its imports, but this time a decrease in imports would result in a paralysis of the manufacturing sector.

Thus, a new period began in 1964 with a policy of stressing export diversification. This quite successful policy involved a number of tax credit and tax incentive programs. At first a crawling peg exchange rate was adopted. In other words, the exchange rate was tied to the rate of inflation so that Brazil's currency would not become overvalued and hinder Brazil's ability to compete in the international market.

The import substitution strategy was based on attracting multinational corporations with the large Brazilian market. For instance, in the 1950s Volkswagen was attracted by the market of 70 million Brazilians and did not want to be left out even if the venture was not too profitable in the short term. If the Brazilian government had told Volkswagen from the very beginning that 60 percent of what they produced in Brazil had to be exported, it is very doubtful that the company would have come in. However, once they were in Brazil and had invested a few billion dollars of capital, then it was much easier for Brazil to nudge the multinationals to collaborate in efforts to diversify exports.

Negative Side Effects of Industrialization

In Brazil, as in most Latin American countries, the rate of rural-urban migration is high. Cities have been growing twice as fast as the country at large. The population might be growing at a rate of 3 percent, while the urban population is growing at 6 to 7 percent. How do the people who come to the cities find jobs?

In Brazil most of the industries that were established did not provide jobs. Some economists have accused the policymakers of not trying to encourage the use of labor-intensive technology.

Another problem was that rapid growth based on industrialization resulted in substantial increases in the concentration of income. This is still a serious problem in Brazil. Industrialization also increased the regional concentration of economic activity. This is true both in Brazil and in the rest of Latin America.

Since the mid-1960s Brazil, as a matter of policy, has encouraged multinational corporations to invest there, especially in export-oriented activities, and has substantially expanded investment in state enterprises. In addition various incentives to encourage export-oriented activities by both multinationals and the domestic private sector have been used. Thus, by the mid-1980s, over 50 percent of exports consisted of industrial products.

Industrial Policy Instruments

The Planning Ministry

The role of Brazil's Planning Ministry depends on the personality of the planning minister. The present (1979-1985) incumbent is a very strong leader who, with the active support of the president, tries to control other ministries. This means that currently the Planning Ministry is extremely important in the allocation of investment resources.

State Enterprises

The state controls 60 percent of the steel industry, all the oil prospecting industry, a large proportion of the petrochemical and mining sectors, and all public utilities and transportation, except the airlines. Through the Air Force, the state has founded a very successful aircraft industry which manufactures mainly 14- to 20-passenger airplanes. These have sold well in the United States. Brazil imports the engines, but the airframe was developed by Brazilian engineers. Besides basic industry and public utilities, the state controls about 60 percent of commercial banking activities and is still dominant in investment banking.

Up to very recently Brazil had to import 85 percent of its petroleum from abroad; by 1985 this had declined to 50 percent. Therefore the government decided to develop the alcohol car—not gasohol, but 100 percent alcohol. This meant a huge program to subsidize distillery equipment production. It meant a huge incentive program to encourage farmers

to produce more sugar cane for the distilleries, the automobile industry to adapt technology for the production of alcohol cars, and the consumer to buy alcohol-driven cars. This scheme has been very successful. In fact, in 1985, 90 percent of the new cars sold were alcohol-driven. This is another instance of the state taking the lead and getting the collaboration of the multinationals, the private Brazilian sector, and state companies in achieving a very important policy goal.

The Development Bank

A substantial amount of the Development Bank's resources comes from forced worker savings plans tied to the social security system. In turn, the Development Bank gives subsidized loans for certain favored sectors. For example, the development of the capital goods industry which boomed in the 1970s was basically financed by the development bank.

Tax Incentives

The Brazilians used tax incentives at first to balance out regional development. For example, businesses that located in the backward northeast area of Brazil could use 50 percent of the taxes owed to the government to invest in that backward region. Later this program was extended to the export sector, then to the aircraft industry where the private sector could participate, and to quite a number of other industrial and agricultural sectors that the state wanted to favor. In other words, resources were allocated through tax incentives.

Issues Brazil Faces

State Enterprises

A central issue that the state faces in Brazil is how to judge the state enterprises in the Brazilian economy. It is very hard to determine how effective the state has been. Some maintain that the state is basically inefficient and others maintain that it is too efficient. The state enterprises were inefficient when Brazil had a fairly open popular government. There was substantial pressure on state enterprises to hire more workers than they needed or to invest in regions which were politically favored, whether or not they were economically viable.

At the height of the military dictatorship, most state enterprises became relatively self-sufficient. They could set tariffs at whatever levels they wished and could carry on their activities without any regard to where

investments should take place, but just with regard to maximizing internal returns. Some would say the state enterprise functioned beautifully in those days; others would disagree, saying that the state enterprise had simply become a capitalist enterprise with no interest in social returns.

It is very difficult to decide this matter. For example, suppose that the state wants to use its steel firms to provide cheap inputs for favored industries. That might make sense from the point of view of global strategy, but it makes it hard to judge whether or not the state steel enterprise is performing adequately if it experiences losses or if its rate of return of investment is inadequate.

In the last few years certain areas of the private sector have called for a greater privatization of state enterprises, saying that they are a danger to the private sector. However, this accusation is hard to prove. There are very few instances in Brazil where the state has stepped into an area which legitimately ought to have been occupied by the private sector. For example, steel. Who would have gone into that sector? Providing electricity. What private Brazilian firms would have been able and willing to enter that sector?

The privatization movement also does not make much sense when one considers that there are no private domestic groups who could buy Petrobras, the largest Brazilian firm. Who is going to buy the large steel firms? Certainly no private group in Brazil has the money to buy them up. But even if they did, such a purchase would lock up funds which ought to be used by the private sector in developing more efficient technology.

Research and Development

Sooner or later R&D is going to be a very important issue for the Brazilian state. The evolution of the current situation explains why. One of the problems in the industrialization of Brazil was the lack of labor absorption, and some economists said that Brazil should have adopted policies to force firms to use more labor-intensive technology. However, if Brazil had adopted more labor-intensive technology 50 or 60 years ago, it would have been condemned permanently to lag behind the industrialized world.

At the present time many Brazilians, at least political and economic leaders, would like to see Brazil's industry transformed gradually into a modern industry that contributes to the development of technology.

When the Brazilians decided to diversify their exports, both multinational and national firms were automatically forced to adopt the most up-to-date technology. The original technologies that had been introduced in Brazil in the early days of import substitution were second-

hand, i.e., the second-hand equipment that Volkswagen and General Motors and Ford and General Electric brought to Brazil. As soon as these companies were forced to compete in the international market, they were no longer interested in second-hand technology. Almost 100 percent of investment in Brazil is based on the most up-to-date type of technology possible, but it is not technology developed in Brazil.

Sooner or later a conflict will arise between the industrial interests of Brazil and the industrial interests of the United States and Western Europe because almost none of the multinational firms have genuine R&D laboratories in Brazil. They are not interested in developing technology in Brazil because their "trump card" in international bargaining is their technology.

On the other hand, Brazilian universities are not equipped at present to do R&D. That is unfortunate. The Brazilian physicist who wants to win a Nobel Prize had better go with General Electric or to an American university because there is no possibility for him to do the type of work in Brazil which will do some good for his country and also win him glory in the international scientific world.

The Brazilian Debt

The debt dominates Brazilian economic policymaking today. The indebtedness of Brazil cannot be blamed solely on the industrialization model it adopted. The forces that contributed to Brazil's indebtedness were beyond the control of Brazilian policymakers.

With a $105 billion dollar debt the Brazilians are forced to export. In late 1983 the Brazilians, as well as the Koreans, were successful in exporting steel, for example, to the United States. However, leaders of the steel industry in the United States are fighting tooth and nail to keep the Brazilians and Koreans out of the U.S. market because they want time to "modernize." (Could we call it "modernizing" when U.S. Steel bought Marathon Oil Company?) The question is how on earth can Brazil get out of the debt trap if it cannot receive some political support in the United States and Western Europe and Japan to increase its market. Something has to give. There is a tremendous contradiction here. If the United States is going to keep exports from Brazil out, then Citicorp and Chase Manhattan had better find some other solution to the debt.

6.

Implications for U.S. Trade and Aid Policy

Ernest H. Preeg

If industrial policy is defined as a conscious government policy to channel resources to specific industries or sectors, it is nothing new. Governments, including the U.S. government, have always done this. Trade policy, in fact, is the most potent force most governments utilize to favor some industries over others. For example, the recent voluntary export quotas on Japanese cars shipped to the U.S. market resulted in a transfer of billions of dollars of resources to the U.S. automotive sector, larger than the most ambitious schemes for an industrial development bank. Similarly, aid policies are often designed to provide concessionary credit and technical assistance to particular sectors of the recipient country's economy considered most promising and necessary for the national development (or industrial strategy).

Having said that, why has the discussion of industrial policy become more intense over the past few years? I believe the answer lies both in changes that have taken place in the policy orientation of governments and in the greater direct competition being faced by U.S. economic interests in many sectors. This, in turn, has highlighted policy conflicts that exist between the market-oriented principles of the GATT trading system and the targeted government support, explicit or implicit, in industrial policy initiatives.

Changes in the Policy Orientation/Economic Interests

The composition of U.S. trade and other economic interests abroad has changed considerably over the past decade. Three relationships stand out in terms of the industrial policy debate: Japan, Western Europe, and the newly industrializing countries. Japan remains at the forefront of concern about industrial policies, including unfair trading practices, that

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The GATT

The General Agreement on Tariffs and Trade was founded in 1948. It is dedicated to the expansion of multilateral trade and the conciliation and settlement of international trade disputes. Ninety-one nations currently belong to the GATT, which has held a total of seven rounds of multilateral trade negotiations; the last round (1973-1979) was known as the Tokyo Round. A basic foundation of the GATT in the principle of non-discriminatory trade between member nations on the most-favored-nation principle.

are detrimental to U.S. interests. The enormity of the bilateral trade deficit with Japan colors thinking at every turn. And yet, as we have heard today, Japanese industrial policy, as it was used effectively in the 1950s, has been largely phased out. Large government subsidies and total import protection for domestic industry are rarely the case. More subtle, institutional favoritism exists, and macro-policy strategy can play a major role in favor of Japanese industry, but these are more elusive targets for a U.S. policy response, particularly in the trade policy field.

The relationship with Western Europe has been influenced by a general trend toward more government intervention, more public sector participation, and more industrial policy in its broadest terms. This trend may be bottoming out in some countries, but compared with a decade or two ago, the commitment to a free market economy, as implied in the formation of the Common Market, is muted. To a large extent, the greater public sector involvement has evolved in parallel with a growing sluggishness in the European industrial sector, including much controversy as to cause and effect. One result has been a lessened intensity of direct competition with the United States, at least in the industrial sector. Another is that the basis for a cooperative trade policy framework is less clear than in earlier years.

The third and perhaps most difficult area of changing U.S. trade interests is with the newly industrializing countries of Asia and Latin America. Dynamic industrial development in these countries is causing severe import competition for many U.S. industries. At the same time, the newly industrializing countries, to varying degrees, utilize potent forms of national industrial policies to stimulate new industry while largely refusing to accept the constraints of the GATT trading system. Cries from U.S. industry of unfair trading practices and the lack of reciprocal access to markets, together with difficult structural adjustment problems, are leading to a more and more conflicted trading relationship with these countries.

Overarching these various country relationships is a new wave of technological change, centrally focused on the information technology and telecommunications sectors, that raises fundamental questions about the relation between trade and national industrial policies. The enormity and rapidity of this "high tech revolution" raise the question of whether governments have the competence to direct the future path of such industrial change. The international character of its development, production, and marketing questions the limits and usefulness of inward directed national strategies. U.S. experience and policy demonstrate dramatic economic progress from an open market approach. Japan is not that far behind in its current treatment of high tech industry. Many other countries, however, supply far greater governmental support for domestic firms, with France and Brazil among the more articulate proponents of a highly protectionist approach for this gargantuan "infant industry."

The Conflict between the GATT and Industrial Policy

The policy issue currently faced in many situations is a basic conflict between the principles of the GATT world trading system that came into existence in the late 1940s and the idea of favoring selected industries, as implied in most industrial policy strategies. The GATT is based on the ideal of a free allocation of resources, unfettered by the distortions of governmental intervention, which would include much of the substance of industrial policy. The first stage, under the GATT system of trade rules, is to put existing trade barriers on a non-discriminatory basis, preferably tariffs rather than quotas or other non-tariff restrictions. The tariffs are then to be progressively reduced, as feasible, on a balanced, reciprocal basis. Government policies that distort trade, such as subsidies and discriminatory government procurement practices, are to be avoided. Moreover, if one GATT member breaks these rules, others affected by the action have the right to retaliate through restrictions on the trade of the offending country.

The GATT system provides for exceptions to the rules under certain circumstances and is limited in scope primarily to trade in manufactured products. In practice, it has never worked perfectly and suffers from a weak dispute settlement mechanism. Nevertheless, it is only in recent years that the central GATT tenets of non-intervention in markets and non-discrimination among trading partners have been frontally challenged as they currently are by some concepts of industrial policy.

The conflict is most stark at this point with respect to the newly industrializing countries. Although many developing countries are members of the GATT, and some were founding members, they are not gen-

erally bound by the obligations noted above. Developing countries have a general exemption to the extent that prescribed limits in trade restrictions conflict with national development strategy, as determined by the developing country in question. Consequently, developing countries by and large have not committed themselves to non-discriminatory trade barriers and in many cases retain very high or prohibitive levels of protection.

The debate over liberal trade versus heavy-handed industrial policy has, in fact, raged for years in the formation of national development strategies in the Third World. During the 1960s, the so-called dependencia school, particularly popular in Latin America, called for internal support and total protection from imports for certain industries deemed appropriate for national development, in order to reduce "dependence" on imports. Whether it was called "infant industry" or "industrial" strategy, the important point is that the dependencia approach was comprehensive and in open conflict with the GATT trading system.

More recently, and with the realization that the dependencia approach did not generally produce good results, many developing countries, with the strong support of the World Bank and the International Monetary Fund, have espoused export-oriented development strategies, based on a transition to an open trading economy and thus more compatible with GATT rules and principles. The debt crisis of 1979-80, however, forced a retreat by some debtor countries from the open approach, and the debate about the export-oriented development strategy continues.

What makes the policy conflict vis-a-vis the newly industrializing countries particularly acute at this stage is that these countries are highly competitive in a growing range of industries and this competitiveness causes serious adjustment problems for firms and workers in industrial countries displaced by imports. The dependencia debate of the 1960s affected markets in the developing world and was remote to U.S. industry. An industrial policy by the newly industrializing countries to stimulate industry to export to the U.S. market, in contrast, is a direct challenge, and is eliciting strong political hues and cries from domestic constituencies adversely affected. Some academic economists are joining the debate, pointing out that if the United States continues to follow the GATT approach while the newly industrializing countries pursue an industrial strategy that subsidizes targeted export sectors, the gains from trade may evaporate and turn negative from the U.S. point of view.

Aid Policy and Industrial Policies

The formulation of foreign assistance or aid policies encounters similar questions with respect to industrial policy, although the issue is

not as central or as sharply drawn as in the area of trade policy. A large part of economic aid is directed to peasant agriculture for domestic food production, education and health services, and infrastructure projects, none of which is directly relevant to industrial policy. Other assistance takes the form of program or sector loans, usually conditional on policy changes by the recipient government. The policy conditionality sought in recent years by the World Bank, the U.S. Agency for International Development (USAID), and most other donors generally has been in the direction of freer markets internally and lower import barriers. In other words, the conditionality has been in the direction of the GATT market-oriented rules rather than a targeted industrial policy.

The potential conflict is greatest in the area of project-related foreign assistance. For example, to be viable some industrial projects might require restrictions on competing imports, which would build in new trade barriers contrary to the GATT approach of a progressive lowering of trade barriers. On the export side, highly concessionary credit or grant aid for new enterprises raises the question of unfairly subsidized export competition. USAID and U.S. votes in the multilateral development banks would not, for example, approve projects in such sectors as textiles and footwear, or for certain agricultural products that compete directly with U.S. products.

The aid policy issue is circumscribed somewhat by the fact that most of the newly industrializing countries are aid "graduates," and therefore do not receive USAID support or highly concessionary lending from multilateral development banks. Nevertheless, they remain eligible for normal development bank facilities, which means long-term credit at somewhat favorable terms. This can raise serious questions: for example, is a new steel mill targeted for exports, as part of a national development strategy, compatible with trade policy objectives formulated elsewhere and which attempt to cope with an already glutted world market for steel?

Policy Options for the United States

The United States has two basic policy options. Our government could develop a forceful industrial policy of our own to try to offset what other countries are doing, particularly in the trade field. Or we could continue our predominantly open market, liberal trade approach, while bringing pressure to bear on our major trading partners to move definitively in that direction as well. This does not mean a purist approach of total free trade with no government role in managing the course of industrial development. Government-supported R&D, for example, is a fact of life in all major countries, although in some controversial areas narrowly

targeted R&D can be considered a form of export subsidy. Similarly, tax policy, particularly with respect to investment credits, can favor certain sectors or industries. But the contrast between the current circumstances in the United States and those in a number of our trading partners is sharp enough to warrant the either/or presentation of policy options.

The crucial point is that the current state of affairs is not stable or sustainable. Either we convince others to open their markets progressively toward the GATT norms, or we will perforce respond with some form of countervailing industrial policy of our own, be it an elaborately tailored set of industrial targets or, more likely, a less orderly barrage of new trade barriers. The economic experience of recent decades would argue strongly in favor of the former option—but political attitudes, at home and abroad, may well carry the day for the latter alternative.

The content of the preferred liberal trade alternative would consist of three distinct, though related, parts. First would be a higher degree of complementarity in macro-policy adjustment by the major currency countries. The over-valued dollar and under-valued yen of recent years are causing trade imbalances that simply cannot be sustained. Second would be an increasing emphasis on bilateral trade negotiations to open access to foreign markets to a degree more comparable to that currently enjoyed in the U.S. market. U.S.-Japanese negotiations over the past couple of years may be the precursors for similar approaches to Taiwan, South Korea, and other countries with large trade surpluses with the United States. And third, a new round of multilateral GATT negotiations is being launched to strengthen GATT procedures and commitments by all members, including a further liberalization of trade on a mutual basis. The United States has been pressing for such multilateral negotiations since 1982, and the lack of enthusiasm shown by some other countries, particularly some newly industrializing countries, is an indication of the difficult choice posed between a deeper commitment to GATT trading rules and autonomy to pursue a highly targeted industrial policy.

The scenario for the more restrictive approach, whereby the United States would attempt a forceful industrial p- icy of its own, is more difficult to specify. Import restrictions and financial support for selected U.S. industries would run the clear risk of a chain reaction by our trading partners. Whether it would trigger a repeat of the experience of the 1930s, wherein world trade declined dramatically, is an open question. In any event, the more the market-oriented norms of GATT are supplanted in official thinking by national objectives of self-sufficiency or export promotion through government intervention, the more vulnerable the existing trading system becomes. In some circumstances, there can be strong attraction and convergence between the concepts of "industrial policy" and "beggar-thy-neighbor," however different they may sound.

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